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BEFORE THE ARIZONA CORPORATION COMMISSION

3252

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Arizona Corporation Commission

DOCKETED

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IN THE MATTER OF QWEST
CORPORATION'S FILING OF RENEWED
PRICE REGULATION PLAN.

DOCKET NO. T-01051B-03-0454

IN THE MATTER OF THE
INVESTIGATION OF THE COST
OF TELECOMMUNICATIONS
ACCESS.

DOCKET NO. T-00000D-00-0672

NOTICE OF FILING

The Residential Utility Consumer Office ("RUCO") hereby provides notice of filing the Surrebuttal Testimonies of Marylee Diaz Cortez and William A. Rigsby; and the Redacted Surrebuttal Testimony of Dr. Ben Johnson in the above-referenced matter.

RESPECTFULLY SUBMITTED this 12th day of January, 2005.

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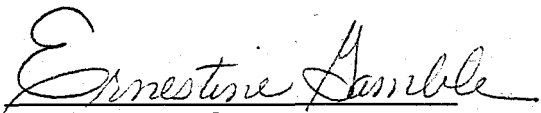
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IN THE MATTER OF QWEST CORPORATION'S
FILING OF RENEWED PRICE REGULATION PLAN

DOCKET NO. T-01051B-03-0454

and

IN THE MATTER OF THE INVESTIGATION OF
THE COST OF TELECOMMUNICATIONS ACCESS

DOCKET NO. T-00000D-00-0672

SURREBUTTAL TESTIMONY

OF

MARYLEE DIAZ-CORTEZ

ON BEHALF OF THE

RESIDENTIAL UTILITY CONSUMER OFFICE

JANUARY 12, 2005

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INTRODUCTION

Q. Please state your name for the record.

A. My name is Marylee Diaz Cortez.

Q. Have you previously filed testimony in this docket?

A. Yes. I filed direct testimony in this docket on November 18, 2004.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to respond to various arguments and opinions Qwest witnesses have set forth in their rebuttal testimony.

Q. What issues will you discuss in your surrebuttal testimony?

A. In my surrebuttal testimony I will respond to Qwest's rebuttal arguments concerning the following RUCO recommended adjustments:

- * Rate Base Adjustment #1 - Accumulated Depreciation
- * Rate Base Adjustment #2 - Capitalization of Software
- * Rate Base Adjustment #3 - Construction Work in Progress
- * Rate Base Adjustment #4 - Accumulated Depreciation - Station Apparatus
- * Rate Base Adjustment #5 - Pension Asset
- * Rate Base Adjustment #6 - Postretirement Benefits
- * Fair Value Rate Base

- * Operating Adjustment #2 - Projected Changes in Test Year Revenues
- * Operating Adjustment #8 - Property Taxes
- * Operating Adjustment #9 - Incentive Compensation
- * Other Agreed on Adjustments

RATE BASE

Rate Base Adjustment #1 - Accumulated Depreciation

Q. Please discuss the Company's rebuttal comments concerning Rate Base Adjustment #1 - Accumulated Depreciation.

A. The Company argues that because it is not restating its books and records to reflect it's proposed proforma decrease to the test year Accumulated Depreciation balance, there is no potential for double recovery.

Q. Does your concern regarding double recovery of prior depreciation expense have any connection to whether or not the Accumulated Depreciation balance is actually decreased on Qwest's books and records?

A. No. Whether or not Qwest's proforma decrease in the Accumulated Depreciation balance is recorded on the Company's books and records has no bearing on double recovery. If Qwest is allowed to restate its test year Accumulated Depreciation, as if the test year depreciation had never been collected through rates, Qwest will recover the test year

1 depreciation expense twice, once in the rates that were in place during the
2 test year and again through the rates and tariffs set in this docket.

3
4 **Rate Base Adjustment #2 -Capitalization of Software**

5 Q. Have you reviewed the Company's rebuttal comments regarding your
6 Rate Base Adjustment #2 and Operating Adjustment #4 - Capitalization
7 and Amortization of Software?

8 A. Yes.

9
10 Q. Are RUCO and Qwest in agreement on the appropriate adjustment for the
11 capitalization of software costs?

12 A. Yes. Qwest has revised its requested rate base and operating income to
13 reflect the same adjustment as recommended in my direct testimony.
14 There are some small discrepancies in amounts of the two adjustments
15 however the adjustments are materially and conceptually the same. The
16 Company's revisions are shown on Company Exhibit PEG-R4.

17
18 **Rate Base Adjustment #3 - CWIP**

19 Q. Please discuss Qwest's rebuttal comments regarding Rate Base
20 Adjustment #3 and Operating Adjustment #7.

21 A. Qwest continues to argue that its CWIP balances should be included in
22 rate base with a credit to operating revenues to avoid double counting
23 AFUDC (interest) accruals with the proposed rate base recovery

1 treatment. The Company claims that it proposed treatment is the only
2 method that will allow full recovery of its CWIP capital costs and
3 accordingly recommends that Staff and RUCO's recommendation for rate
4 base exclusion and AFUDC accrual be denied.

5
6 Q. Typically, does the Commission include CWIP balances in rate base?

7 A. No. The Commission typically applies the used and useful test in
8 determining rate base treatment, which by definition excludes rate base
9 recognition of CWIP.

10
11 Q. How does the utility recover the carrying costs of its CWIP if it is excluded
12 from rate base?

13 A. Under the Uniform System of Accounts a utility is allowed to accrue its
14 construction carrying costs in the form of AFUDC. These AFUDC
15 accruals are capitalized and then recovered over the useful life of the
16 asset through depreciation expense.

17
18 Q. Do you agree with the Company's argument that only its proposed
19 "revenue offset" method allows it to recover its full cost of construction?

20 A. No. The Company's exhibit (PEG-D4) that purports to prove this
21 argument is not accurate. First it assumes that only 80% of the AFUDC
22 accruals under RUCO's recommended methodology will be ultimately rate
23 based. The analysis on exhibit PEG-D4 also assumes that the rate base

1 value of the asset will decrease each year as the asset depreciates, and
2 therefore the recovery of the return will decrease each year. This is
3 inaccurate. Yes, the net book value of the asset will decrease each year
4 on the Company's books, but unless there is a rate case each year, the
5 rate base value will remain unchanged. This continues to allow the
6 Company to earn on the undepreciated value of the asset.

7
8 Q. Do you continue to oppose the Company's "revenue offset" method of
9 accounting for CWIP?

10 A. Yes. The Company has presented no compelling reason why the
11 Commission should depart from its typical CWIP ratemaking treatment
12 and has failed to prove its argument that the typical Commission treatment
13 does not afford the Company an opportunity to recover its full cost.

14
15 **Rate Base Adjustment #4 - Accumulated Depreciation - Station Apparatus**

16 Q. Please discuss Qwest's rebuttal arguments concerning your Rate Base
17 Adjustment #4 - Accumulated Depreciation Station Apparatus.

18 A. The Company claims in its rebuttal testimony that the accumulated
19 depreciation balance associated with the Station Apparatus account *is*
20 included in the test year rate base balance, and thus RUCO's adjustment
21 is unnecessary.

1 Q. In light of the Company's claims have you revisited this issue?

2 A. Yes. I reviewed Schedule B-4 of the Company's application which clearly
3 shows a balance in plant account 2311 - Station Apparatus of \$32.9
4 million. I also reviewed the Company's response to RUCO data request 4-
5 6 which provided a schedule of test year accumulated depreciation
6 balances for each plant account. There is no accumulated depreciation in
7 account 2311 - Station Apparatus. Thus, based on the data provided to
8 me by the Company, it continues to appear that the Station Apparatus
9 accumulated depreciation balance has been omitted from the Company's
10 rate base, and that RUCO's adjustment is necessary.

11
12 **Rate Base Adjustment #5 - Pension Asset**

13 Q. Please discuss the Company's rebuttal arguments regarding RUCO Rate
14 Base Adjustment #5 - Pension Asset.

15 A. The Company's rebuttal claims that the RUCO Pension Asset adjustment
16 is a "red herring" and should be rejected.

17
18 Q. What is the Company's basis for this conclusion?

19 A. It is not entirely clear how the Company reached this conclusion. The
20 Company's argument centers around the assumption that RUCO has
21 excluded the Pension Asset from rate base because the Company has
22 failed to recognize \$511 million in Other Liabilities on its balance sheet in

1 rate base. Qwest further claims that no weight can be given the
2 Company's balance sheet (Schedule E-1) in determining rate base.

3 Q. Do you agree with the Company's comments?

4 A. No. While I do point out in direct testimony that recognition of a Pension
5 Asset of over \$97 million in rate base without a corresponding analysis of
6 the Other Liabilities account is inherently biased, this is not the only
7 reason for my recommendation to exclude the Pension Asset balance
8 from rate base.

9
10 Q. What other reasons did you have for your recommendation?

11 A. As previously discussed in my direct testimony, Qwest has a test year rate
12 base of \$1,647 million and a test year capital structure of \$1,653 million.
13 Thus, Qwest's claim of investor supplied capital for an Arizona pension
14 asset is not possible since the \$1,653 million in actual Arizona capital
15 investment is sufficient only to support Qwest's test year rate base (which
16 does not include a pension asset). I also note that the Commission
17 denied Qwest's rate base treatment of the Pension Asset in a prior case.
18 These points remain unrebutted in the Company's testimony.

Rate Base Adjustment #6 - Postretirement Benefits

Q. Have you reviewed the Company's rebuttal comments to your Rate Base Adjustment #6 and Operating Adjustment #5 - Postretirement Benefits?

A. Yes. It appears RUCO's position is consistent with the Company's position on the treatment of the Post Retirement Benefits. In its rebuttal testimony, the Company updates its adjustment to reflect the most recent estimate of the accumulated postretirement benefit obligation, and to correct and error in the rate base portion of this adjustment. These Company acknowledged corrections and updates accomplish the same purpose as RUCO Rate Base Adjustment #7 and Operating Adjustment #5.

Fair Value Rate Base

Q. Please discuss the Company's rebuttal comments regarding fair value rate base.

A. The Company argues in its rebuttal testimony that Arizona law requires that the Commission make a finding of fair value rate base in the context of setting rates.

Q. Do you agree with this position?

A. Yes. The Company is correct. Arizona law requires a finding of fair value rate base. However, I do not agree that the Commission must apply an

1 original cost rate of return to that fair value rate base, as argued by the
2 Company.

3
4 Q. How does the Commission calculate fair value rate base and fair value
5 rate of return?

6 A. In determining a utility's fair value rate base (FVRB), the Commission
7 averages the utility's original cost rate base (OCRB) and its reconstruction
8 cost new depreciated rate base (RCND). The Commission then
9 determines the revenue requirement by multiplying the OCRB by the
10 original cost cost of capital. The fair value rate of return is equal to the
11 revenue requirement divided by FVRB.

12
13 Q. How does the Commission methodology differ from what Qwest has
14 proposed?

15 A. The error in the Company's calculation is its application of the original cost
16 rate of return to the FVRB, thereby deriving a larger than warranted
17 revenue requirement. This methodology is incorrect. When the correct
18 rate of return is applied to the OCRB, RCND, or FVRB *the revenue*
19 *requirement remains constant.* The Company's proposed methodology
20 derives a higher revenue requirement through the use of the FVRB.

1 Q. Why is this incorrect?

2 A. The revenue requirement that a utility is entitled an opportunity to recover
3 through rates is in large part dependant on two factors: the value of its rate
4 base and its cost of capital. Both factors need to be stated on the same
5 basis in order to generate fair and reasonable rates. When an original
6 cost rate base and original cost of capital basis are used these two factors
7 are appropriately matched. The original cost rate base does not consider
8 inflation, as does the RCND rate base. However, the original cost of
9 capital utilized in a rate case *does* consider inflation in both the cost of
10 debt analysis (i.e. as an interest rate component) and the cost of equity
11 analysis (i.e. in the risk component). Thus, when an original cost rate
12 base is multiplied by an original cost of capital the inflation element is
13 present in the resultant revenue requirement as a component of the cost
14 of capital. If an original cost rate base is replaced with a FVRB rate base
15 the inflation factor will be double counted in the revenue requirement
16 calculation. This double count results because both the RCND rate base
17 (which represents 50% of the FVRB) and the original cost of capital
18 include an inflation factor. When multiplied together in the revenue
19 requirement calculation, the inflation factor will be compounded and result
20 in a double count, which will overstate the revenue requirement.

1 **OPERATING INCOME**

2 **Operating Adjustment #2 - Projected Changes in Test Year Revenues**

3 Q. Have you reviewed Qwest's rebuttal comments concerning your Operating
4 Adjustment #2 - Projected Changes in Test Year Revenues?

5 A. Yes. Qwest denies that its proposed revenue decrease adjustment is
6 based on projections, and further claims that the \$44.7 million decrease in
7 revenues it has proposed is "known and measurable".

8
9 Q. Do you agree that the proforma decrease in revenue the Company has
10 reflected in its filing is "known and measurable"?

11 A. No. The proforma decrease in revenues is based on a number of
12 assumptions, which include the assumption that a change in certain
13 independent variables will have a one-to-one impact on the dependent
14 variable, which in Qwest's proposed adjustment is its revenue. Qwest
15 relies on regression analyses to support this assumption. Yet, none of the
16 Company's regression analyses show a one-to-one correlation between
17 the independent variable and Qwest revenue. Despite the absence of a
18 one-to-one correlation, the Company's projected revenue decrease
19 adjustment relies on the existence of a one-to-one relationship.

20
21 Q. How did Qwest characterize this adjustment in its original filing?

22 A. Qwest characterized the proposed proforma revenue decreases as
23 "Forecast Amounts" in its filing.

Operating Adjustment #8 - Property Tax Expense

Q. Please discuss Qwest's rebuttal comments pertaining to Operating Adjustment #8 - Property Taxes.

A. Qwest's claims that the property tax rate and the full cash value used in RUCO's property tax calculation are incorrect.

Q. Do you agree that your calculation does not render an accurate full cash value?

A. No. My calculation utilizes the formula ADOR uses to calculate telephone property taxes, which is defined under Arizona Revised Statute §42-14403. The formula is based primarily on the book value of Qwest's Arizona property. By utilizing the test year adjusted net plant in my calculation I have captured only the property tax related to regulated Arizona jurisdictional plant. This is the only portion of the property tax expense that ACC jurisdictional customers should be responsible for. Qwest has suggested that I should have used the full cash value as determined by ADOR on its 2004 notice of valuation, which has not been adjusted to reflect solely the regulated ACC jurisdictional property.

Q. Had you utilized the amount suggested by Qwest, how would that differ from your calculation using test year adjusted net plant?

A. The full cash value shown on ADOR's 2004 notice of valuation is \$2,583,351,359. That amount would have to be jurisdictionalized and

1 then the ACC jurisdictional amount multiplied by the 25% assessment
2 ratio. This methodology would yield a property tax expense of
3 approximately \$1.2 million more than my calculation does using the net
4 adjusted test year values and a property tax expense that is \$8 million less
5 than the amount proposed by Qwest.

6
7 Q. Please respond to the Company's comments regarding the property tax
8 rate used in your calculation.

9 A. The Company claims the 2004 average state property tax utilized in my
10 calculation is incorrect, and that I should have used the actual 2003 tax
11 rate, which is slightly higher.

12
13 Q. How did you obtain the 2004 average state property tax rate that you used
14 in your property tax calculation?

15 A. I spoke with an ADOR employee in the telephone property tax division and
16 was provided with the 12.18% 2004 rate. ADOR applies the 2004 tax
17 rate to the 2003 net plant values to determine the 2004 property tax
18 assessment. My calculations employ this same methodology.

19
20 Q. Even if you were to modify your calculations based on the Company's
21 rebuttal arguments would the resultant property tax expense be materially
22 different than in your original calculation?

23 A. No.

Operating Adjustment #9 - Incentive Compensation

Q. Have you reviewed the Company's rebuttal comments regarding Operating Adjustment #9 - Incentive Compensation?

A. Yes. In response to my direct testimony stating that ratepayers should not be required to pay higher rates to fund rewards for poor operating results, the Company opines that I have not shown that the test year incentive compensation costs are unreasonable business expenses.

Q. Please respond.

A. It appears the Company did not understand the rationale for my incentive compensation adjustment. By definition the incentive compensation rewards are unreasonable expenses when the Company operated at a loss, yet rewarded its employees anyway. Further, the awards themselves exacerbated the Company's losses and contributed to the need for even higher rate increases. Under these circumstances the incurrence of these expenses was unreasonable.

OTHER AGREED ON ADJUSTMENTS

Q. In addition to those already specifically address in your surrebuttal testimony, are Qwest and RUCO in agreement on any other adjustments?

A. Yes. Qwest and RUCO agree on: RUCO Rate Base Adjustment #6 and Operating Adjustment #1/Qwest PFA-01 and RUCO Operating Adjustment #3/Qwest PFN-12.

1 Q. Does this conclude your surrebuttal testimony?

2 A. Yes.

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IN THE MATTER OF QWEST CORPORATION'S
FILING OF RENEWED PRICE REGULATION PLAN

DOCKET NO. T-01051B-03-0454

and

IN THE MATTER OF THE INVESTIGATION OF
THE COST OF TELECOMMUNICATIONS ACCESS

DOCKET NO. T-00000D-00-0672

SURREBUTTAL TESTIMONY

OF

WILLIAM A. RIGSBY

ON BEHALF OF THE

RESIDENTIAL UTILITY CONSUMER OFFICE

JANUARY 12, 2005

1	INTRODUCTION	1
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3	COST OF EQUITY CAPITAL	3
4		

INTRODUCTION

Q. Please state your name, occupation, and business address.

A. My name is William A. Rigsby. I am a Public Utilities Analyst V employed by the Residential Utility Consumer Office ("RUCO") located at 1110 W. Washington, Suite 220, Phoenix, Arizona 85007.

Q. Please state the purpose of your testimony.

A. The purpose of my testimony is to respond to Qwest Corporation's ("Qwest" or "Company") rebuttal testimony on RUCO's recommended rate of return on invested capital for the Company's telecommunications operations in the state of Arizona.

Q. Have you filed any prior testimony in this case on behalf of RUCO?

A. Yes, I filed direct testimony with the Arizona Corporation Commission ("ACC" or "Commission") on November 18, 2004. My direct testimony addressed the cost of capital issues that were raised in Qwest's application for a permanent rate increase for certain regulated services available to ratepayers under a revised price cap plan ("Application").

Q. How is your surrebuttal testimony organized?

A. My surrebuttal testimony contains three parts: the introduction that I have just presented, a summary of Qwest's rebuttal testimony and a section on

1 the cost of equity capital in which I will defend my recommended cost of
2 capital.

3
4 **SUMMARY OF QWEST'S REBUTTAL TESTIMONY**

5 Q. Have you reviewed the rebuttal testimony of Company witness Peter C.
6 Cummings?

7 A. Yes, I have reviewed Mr. Cummings's rebuttal testimony, which was filed
8 with the Commission on December 20, 2004.

9
10 Q. Please summarize the Company's rebuttal testimony that addresses the
11 cost of capital issues in this case.

12 A. Mr. Cummings's rebuttal testimony provides a comparison of his
13 recommendations with the cost of capital recommendations of ACC Staff
14 witnesses Joel M. Reiker and Alejandro Ramirez, and the cost of capital
15 recommendations presented in my direct testimony. Mr. Cummings points
16 out in his testimony that there are no arguments or disagreements among
17 the witnesses on either the Company's proposed capital structure, or cost
18 of debt. Mr. Cummings rebuttal testimony then concentrates on the main
19 point of contention in this case which is a cost of equity capital that takes
20 Qwest's level of debt into consideration. The remainder of Mr. Cummings'
21 testimony criticizes the approaches employed by Mr. Reiker and myself to
22 arrive at our final recommended costs of common equity of 14.6 percent
23 and 11.5 percent respectively, and argues why his 21.4 percent cost of

1 equity capital, derived by using a levered beta in the capital asset pricing
2 model ("CAPM"), should be adopted by the Commission.

3
4 **COST OF EQUITY CAPITAL**

5 Q. Have you made any changes to your recommended 11.5 percent cost of
6 common equity based on information presented in Mr. Cummings' rebuttal
7 testimony?

8 A. No, I have not.

9
10 Q. Do you believe that the Commission should adopt Mr. Cummings's
11 recommended 21.4 percent cost of equity capital for Qwest?

12 A. No. As I stated on page 54 of my direct testimony, I do not believe that
13 the 21.5 percent cost of equity, produced by the theoretical 2.15 beta
14 calculated by Mr. Cummings, is realistic when companies with similar
15 betas are compared with Qwest. Mr. Cummings has accepted the results
16 of his CAPM analysis with a levered beta without question. In short, he
17 has failed to put any type of sanity check on the results produced by the
18 CAPM model.

19
20 Q. Have you performed such a sanity check?

21 A. Yes, I have. Schedule WAR-10 contains a list of publicly traded
22 companies followed by The Value Line Investment Survey ("Value Line"),
23 which have betas that range from 2.00 to 2.50. I will use the information

1 presented in the schedule¹ to explain why I believe Mr. Cummings'
2 recommended 21.4 percent cost of equity capital is not reasonable.

3
4 Q. Please describe Schedule WAR-10.

5 A. Schedule WAR-10 lists thirty-three publicly traded companies that have
6 betas that range from 2.00 to 2.50. Their combined average beta is 2.15
7 (the same beta calculated for Qwest by Mr. Cummings). Approximately
8 seventy-three percent of the companies are traded on the technology
9 heavy NASDAQ exchange as opposed to the NYSE. All of the
10 companies, with the exception of three, are unregulated and operate in a
11 competitive environment. The three regulated entities include E*Trade
12 Financial, an on-line Internet brokerage service that is subject to certain
13 state and federal securities regulations, and two firms in the diversified
14 natural gas industry; Williams Companies (which spun off its
15 telecommunications subsidiary in April 2001) and Dynegy whose interstate
16 natural gas transportation operations are subject to FERC oversight. The
17 most dominant industry represented in the list is the semiconductor
18 industry. A total of eight semiconductor firms such as LSI Logic Corp. and
19 Atmel Corp., had betas that ranged from 2.0 to 2.25.

20
21
22

¹ Data was compiled from The Value Line Investment Survey's December 24, 2004 Summary & Index publication.

1 Q. Were any of the companies in your compilation telecommunications
2 service providers such as Qwest?

3 A. Only one unregulated company, American Tower, is exhibited in Schedule
4 WAR-10. None of the other companies that comprise Value Line's
5 telecommunications service industry segment, including the RBOC's, had
6 betas that fell in the 2.00 to 2.50 range.

7
8 Q. Please describe American Tower.

9 A. According to Value Line, American Tower operates approximately 15,000
10 wireless communications and broadcast towers that are primarily leased
11 to wireless providers of personal communications services. The Company
12 has a beta of 2.0 and has a capital structure comprised of approximately
13 66.0 percent debt and 34.0 percent equity. Value Line has estimated a
14 long-term (2007-09) return of common equity of 2.50 percent for American
15 Tower.

16
17 Q. What was the average capital structure of these firms?

18 A. The average capital structure for the companies listed on Schedule WAR-
19 10 was roughly 38.0 percent debt and 62.0 percent common equity as
20 compared to Qwest's 75.0 percent debt and 25.0 percent common equity.
21 However the level of equity among the listed companies ranged from a
22 high of 99.97 for Applied Micro, an unregulated semiconductor firm with a

1 beta of 2.05, to a low of 0.33 for AMR Corp., the parent of American
2 Airlines with a beta of 2.30.

3
4 Q. Did Value Line's analysts estimate higher returns on common equity for
5 companies with higher levels of debt in their capital structures?

6 A. Not necessarily. For example, Williams Companies with approximately
7 81.0 percent debt had an estimated long-term (2007-09) return on
8 common equity of 10.50 percent while Continental Airlines (whose
9 industry has been plagued with high oil costs and reduced travel since
10 9/11) with approximately 88.0 percent debt had an estimated return on
11 common equity of 20.0 percent.

12
13 Q. What was the range and average of Value Line's estimated returns on
14 common equity for the Companies listed in Schedule WAR-10?

15 A. The range (high and low) and average of Value Line's estimated returns
16 on common equity by operating period were as follows:

17
18 2004 2005 2007-09
19 High 17.0% 24.0% 23.5%
20 Low 1.50% 1.50% 2.50%
21 Average 8.16% 9.09% 12.93%

1 Q. Which companies had the high and low estimated returns on common
2 equity for the long-term (2007-09) period?

3 A. The high estimated return on common equity of 23.5 percent was for
4 Avanex Corp., a manufacturer of fiber optic products with a beta of 2.35
5 and a capital structure of 10.0 percent debt and 90.0 percent equity. The
6 low estimate of 2.50 percent was for American Tower, which I described
7 earlier.

8
9 Q. What other information is provided in Schedule WAR-10

10 A. The remainder of Schedule WAR-10 contains Value Line's estimates for
11 returns on common equity for the various industries (i.e. advertising,
12 semiconductor etc.) that are listed in the schedule.

13
14 Q. What is the main point of the information contained in Schedule WAR-10?

15 A. The main point is that the majority of companies operating in competitive
16 environments, with betas ranging from 2.00 to 2.50, that are listed in
17 schedule WAR-10 have nothing in common with Qwest. Qwest is not in
18 the semiconductor industry, the air transport industry or for that matter, the
19 Internet industry such as E*Trade Financial or Priceline.com. Nor is
20 Qwest a manufacturer of telecommunications equipment such as Avanex,
21 Corp. Qwest is, for all practical purposes, a regulated phone company,
22 which, based on the testimony provided by RUCO witness Ben Johnson,
23 is not facing the level of competitive pressure claimed in its filing.

1 Q. Does Mr. Cummings's rebuttal testimony offer any new or compelling
2 reasons why your recommended 8.73 percent rate of return on invested
3 capital does not meet the *Bluefield Water Works* and *Hope Natural Gas*
4 decisions that established the basic criteria for establishing a fair and
5 reasonable rate of return?

6 A. No. Mr. Cummings does not offer any new or compelling reasons as to
7 why my 8.73 percent return on invested capital fails to meet the standard
8 established in those landmark decisions.

9
10 Q. Does your silence on any of the issues or positions addressed in the
11 rebuttal testimony of the Company's witnesses constitute acceptance?

12 A. No, it does not.

13
14 Q. Does this conclude your surrebuttal testimony?

15 A. Yes, it does.

QWEST CORPORATION
DOCKET NO. T-01051B-03-0454
DOCKET NO. T-00000D-00-0672

TABLE OF CONTENTS TO SCHEDULES WAR

SCHEDULE #

WAR - 10

PUBLICLY TRADED COMPANIES WITH BETAS OF 2.00 TO 2.50

QWEST CORPORATION
TEST YEAR ENDED DECEMBER 31, 2003
PUBLICLY TRADED COMPANIES WITH BETAS OF 2.00 TO 2.50

LINE NO.	(A) NAME OF COMPANY	(B) BETA	(C) TICKER SYMBOL	(D) TRADING EXCHANGE	(E) INDUSTRY	(F) REGULATED COMPANY YES/NO	(G) PCT. OF DEBT 2003	(H) PCT. OF COMMON EQUITY 2003	(I) VALUE LINE ESTIMATED ROE 2004	(J) VALUE LINE ESTIMATED ROE 2005	(K) VALUE LINE ESTIMATED ROE 2007-09	(L) VALUE LINE ESTIMATED ROE FOR INDUSTRY 2004	(M) VALUE LINE ESTIMATED ROE FOR INDUSTRY 2005	(N) VALUE LINE ESTIMATED ROE FOR INDUSTRY 2007-09
1	MONSTER WORLDWIDE	2.00	MNST	NASDAQ	ADVERTISING	NO	1.00%	99.00%	13.50%	16.00%	13.50%	11.00%	11.50%	9.50%
2	EXTREME NETWORKS	2.00	EXTN	NASDAQ	COMPUTER PERIPHERALS	NO	46.61%	53.19%	NMF	7.50%	9.00%	14.50%	15.00%	16.00%
3	E-TRADE FINANCIAL	2.00	ET	NYSE	INTERNET	YES	79.10%	61.04%	17.00%	16.00%	13.50%	18.50%	19.50%	25.50%
4	BROOKS AUTOMATION	2.00	BRKS	NASDAQ	MACHINERY	NO	38.36%	29.77%	8.50%	13.00%	16.50%	18.50%	19.50%	25.50%
5	LSI LOGIC CORP.	2.00	LSI	NYSE	SEMICONDUCTOR	NO	28.77%	70.23%	1.50%	2.50%	9.00%	5.00%	6.00%	6.50%
6	JUNIPER NETWORKS	2.00	JNPR	NASDAQ	TELECOM EQUIPMENT	NO	66.26%	33.74%	3.50%	5.00%	2.50%	12.50%	13.00%	11.50%
7	AMERICAN TOWER	2.00	AMT	NYSE	TELECOM SERVICES	NO	40.75%	59.25%	NMF	NMF	NMF	12.50%	8.50%	13.00%
8	EXELIXIS, INC.	2.05	EXEL	NASDAQ	BIOTECHNOLOGY	NO	1.07%	98.93%	NMF	8.00%	14.00%	2.00%	6.50%	12.50%
9	WEBMETHODS, INC.	2.05	WEBM	NASDAQ	E-COMMERCE	NO	57.07%	42.93%	NMF	NMF	17.50%	2.00%	6.50%	12.50%
10	MANUJATHICS GROUP	2.05	MANU	NASDAQ	E-COMMERCE	NO	3.50%	96.10%	NMF	NMF	5.50%	19.50%	20.00%	23.00%
11	POWER-ONE	2.05	PWER	NASDAQ	ELECTRICAL EQUIPMENT	NO	41.00%	59.00%	8.00%	14.00%	20.00%	9.00%	9.50%	12.50%
12	CNET NETWORKS	2.05	CNET	NASDAQ	INTERNET	NO	0.03%	99.97%	NMF	1.50%	7.50%	2.00%	6.50%	14.00%
13	APPLIED MICRO	2.10	AMCC	NASDAQ	SEMICONDUCTOR	NO	0.40%	99.60%	1.50%	2.00%	10.00%	2.00%	9.00%	14.00%
14	INTERWOVEN, INC.	2.10	IWOV	NASDAQ	E-COMMERCE	NO	57.15%	42.85%	3.50%	1.50%	8.50%	1.50%	4.50%	6.50%
15	ADVANCED ENERGY	2.10	AEIS	NASDAQ	SEMICONDUCTOR	NO	35.11%	64.89%	1.50%	4.50%	10.50%	16.50%	16.00%	15.50%
16	RF MICRO DEVICES	2.10	RFMD	NASDAQ	WIRELESS NETWORKING	NO	44.46%	55.54%	NMF	NMF	10.50%	16.50%	24.00%	23.00%
17	SAFEGUARD SCIENTIFICS	2.15	SFE	NYSE	DRUG	NO	80.29%	19.71%	NMF	NMF	NMF	3.00%	3.50%	4.00%
18	MEDARX, INC.	2.15	MEDX	NASDAQ	POWER	NO	0.00%	100.00%	10.00%	13.50%	6.00%	8.50%	9.00%	14.00%
19	CALPINE CORP.	2.15	CPN	NYSE	SEMICONDUCTOR	NO	34.58%	65.42%	NMF	6.00%	16.50%	8.50%	9.00%	14.00%
20	CREE, INC.	2.15	CREE	NASDAQ	SEMICONDUCTOR	NO	0.00%	100.00%	11.00%	11.50%	14.50%	5.00%	6.00%	6.50%
21	VITESSE SEMICONDUCTOR	2.15	VTSS	NASDAQ	TELECOM EQUIPMENT	NO	43.61%	56.39%	14.00%	15.00%	23.00%	8.50%	9.00%	14.00%
22	FOUNDRY NETWORKS	2.15	FDNY	NASDAQ	SEMICONDUCTOR	NO	88.30%	11.70%	NMF	NMF	20.00%	NMF	NMF	50.00%
23	PAC-SIERRA, INC.	2.20	PMCS	NYSE	AIR TRANSPORT	NO	0.05%	99.95%	16.00%	13.50%	13.50%	16.50%	15.00%	15.50%
24	CONTINENTAL AIRLINES	2.25	CA	NASDAQ	COMPUTER SOFTWARE	NO	0.12%	99.88%	1.50%	8.50%	17.50%	8.50%	9.00%	16.00%
25	NULCON COMMUNICATIONS	2.25	NUAN	NASDAQ	COMPUTER PERIPHERALS	NO	33.52%	66.48%	NMF	NMF	NMF	NMF	NMF	50.00%
26	SILICON STORAGE	2.25	SSTI	NASDAQ	SEMICONDUCTOR	NO	45.51%	54.49%	14.50%	24.00%	23.00%	9.00%	9.50%	12.50%
27	ATMEL CORP.	2.25	ATML	NYSE	INTERNET	NO	46.49%	53.51%	NMF	4.00%	13.00%	1.50%	4.50%	6.50%
28	AMR CORP.	2.30	AMR	NASDAQ	WIRELESS NETWORKING	NO	9.79%	90.21%	NMF	NMF	23.50%	5.00%	6.00%	6.50%
29	PRICELINE.COM	2.30	PCLN	NASDAQ	TELECOM EQUIPMENT	NO	80.71%	19.29%	5.00%	9.50%	10.50%	11.50%	11.00%	13.00%
30	OPENWAVE SYSTEMS	2.30	OPWV	NASDAQ	NATURAL GAS (OIL)	YES	75.27%	24.73%	NMF	NMF	5.50%	11.50%	11.00%	13.00%
31	AVANEX CORP.	2.35	AVNX	NYSE										
32	WILLIAMS COMPANIES	2.40	WMB	NYSE										
33	DYNEX, INC.	2.50	DYN	NYSE										
34	AVERAGES	2.15					38.26%	61.74%	8.16%	9.09%	12.93%	9.34%	10.39%	15.27%

REFERENCE:
VALUE LINE INVESTMENT SURVEY - SUMMARY & INDEX DATED 12/24/04

IN THE MATTER OF QWEST CORPORATION'S
FILING OF RENEWED PRICE REGULATION PLAN

DOCKET NO. T-01051B-03-0454

and

IN THE MATTER OF THE INVESTIGATION OF
THE COST OF TELECOMMUNICATIONS ACCESS

DOCKET NO. T-00000D-00-0672

SURREBUTTAL TESTIMONY

OF

DR. BEN JOHNSON
(REDACTED)

ON BEHALF OF THE

RESIDENTIAL UTILITY CONSUMER OFFICE

JANUARY 12, 2005

1 TESTIMONY

2 OF BEN JOHNSON, PH.D.

3 On Behalf of

4 THE STATE OF ARIZONA

5 RESIDENTIAL UTILITY CONSUMER OFFICE

6 Before the

7 ARIZONA CORPORATION COMMISSION

8
9 Docket No. T-01051B-03-0454

10 Docket No. T-00000D-00-0672

11
12 **Introduction**

13
14 **Q. Would you please state your name and address?**

15 **A.** Ben Johnson, 2252 Killearn Center Boulevard, Tallahassee, Florida 32309.

16
17 **Q. What is your purpose in submitting this testimony?**

18 **A.** In this surrebuttal testimony I will be responding to certain portions of the rebuttal testimony of
19 Qwest witnesses Harry Shooshan and David Teitzel. I will also be commenting on positions
20 taken by certain intervenor witnesses concerning issues discussed in my direct testimony. The
21 fact that I do not discuss other portions of the testimony of these witnesses, or the positions
22 taken by other witnesses, should not be construed as agreement with such undiscussed
23 testimony.

1 **Q. Would you please explain how your surrebuttal testimony is organized, and briefly**
2 **summarize its major elements?**

3 A. Yes. Following this introduction, my testimony has two major sections. The first section
4 contains a response to rebuttal arguments proffered by Qwest witnesses Shooshan and Teitzel.
5 I respond to the arguments made concerning appropriate measures of competition and the
6 degree to which intramodal competition can justify Qwest's petition for greater pricing flexibility
7 under its Arizona Price Regulation Plan (the current Plan). I will also address cost recovery as it
8 pertains to Qwest's need for greater pricing flexibility. In addition, I will respond to Qwest's
9 critiques of RUCO's proposed Price Regulation Plan (the recommended Plan) and the role that
10 productivity, if any, should play in such a Plan.

11 The second section contains a response to arguments proffered by Cox Arizona
12 Telcom, L.L.C. (Cox), MCI, Inc. (MCI), The United States Department of Defense (DoD),
13 and the Utilities Division (Staff) of the Arizona Corporation Commission (Commission). As in
14 my response to Qwest's rebuttal arguments, in this section I will examine some of these parties'
15 positions on the status of competition in Arizona markets as well as their recommendations for
16 current Plan modifications. Finally, I will critique some of these parties' positions on the
17 appropriate use of the Arizona Universal Service Fund (AUSF) and switched access rate
18 reductions.

1 **Qwest**

2
3 **Q. In its direct testimony, did Qwest attribute much significance to the issue of**
4 **competition, as it pertained to the Company's proposed revisions to its current Plan?**

5 **A.** Yes. Mr. Teitzel described competition as the impetus behind the proposed revisions.

6
7 It is imperative that the implications of the dynamic competitive
8 environment in Arizona be recognized in the manner in which Qwest's
9 rates are established and in relaxing regulatory guidelines where
10 competition is now thriving. [Teitzel Direct, p. ii]
11

12 **Q. Did the Company attempt to describe the competitive landscape in Arizona?**

13 **A.** Yes. In addition to describing it as "dynamic" in the previous quote, Mr. Teitzel devotes over
14 fifty pages of his direct testimony to describing the activities and successes of carriers he
15 considers Qwest's competitors. After reading this discussion, one is left with the impression
16 that Qwest is facing significant competitive pressures across its Arizona serving area.

17
18 **Q. Did you present an alternate view of the competitive landscape in your direct**
19 **testimony?**

20 **A.** Yes. I painted a picture that was not so rosy. Namely, high barriers to entry still exist for
21 carriers wishing to enter the market. This is evidenced by the relatively high market shares still
22 enjoyed by Qwest across much of its territory, and the high 4-firm concentration ratios and
23 Herfindahl-Hirschmann Indices (HHIs) seen in Qwest wire centers. Further, market
24 abandonment by some major carriers and potential reduction in UNE availability going forward

1 may slow or reverse the trend toward increased competition.

2
3 **Q. Have any of the other intervenors painted a similar picture?**

4 **A.** Yes. Cox witness Lafferty also disputes Qwest's view of the competitive landscape.

5
6 Qwest continues to serve the majority of customers in the state with
7 recent trends suggesting the spread of competition is decreasing. ...
8 Recent regulatory and legal decisions and other trends suggest
9 competition for Qwest's basic wireline services will decrease -- not
10 increase -- in the near future. [Lafferty Direct, p. 3]
11

12 Time Warner Telecom of Arizona LLC witness Gates takes a similar position.

13
14 Qwest has overstated the extent to which it is subject to competition in
15 Arizona. ... Qwest maintains dominance in Arizona. In addition, Qwest
16 continues to benefit from its position as the monopoly provider of
17 special access services, which allows it to realize monopoly profits and
18 to control the strength and viability of its competitors. [Gates Direct, p.
19 3]
20

21 Staff witness Fimbres also takes a similar position.

22
23 While some wire centers have all four forms of competition (resale,
24 UNE-L, UNE-P & facilities bypass), the competitive gains in the nearly
25 9 year window since the 96 Telecom Act was passed highlight slow
26 progress with little to support that acceleration is imminent. ... While the
27 tariffs illustrate opportunities for broad residence and business local
28 exchange service competition, the available evidence indicates that most
29 of the 10 CLECs identified by Qwest are focused on providing
30 business services. Only Cox appears to have a major emphasis on
31 residence service. Only Cox appears to be committed to wide-spread,
32 residential, facilities-based competition, the only form of local exchange

1 service provisioning that allows for full local exchange service
2 differentiation. [Fimbres Direct, pp. 11, 12]
3

4 **Q. How did Qwest respond to your competitive picture?**

5 A. Qwest's witnesses criticized the manner in which I measure competition and the manner in
6 which I dealt with intramodal competition.
7

8 **Q. Would you please outline Qwest's first criticism?**

9 A. Yes. Mr. Teitzel states in his rebuttal testimony:

10
11 The term "effective competition" does not appear in any Arizona rule or
12 statute that is relevant to this docket. ... The term "effective
13 competition" is not only missing from the Commission's rules, it is a term
14 that may have multiple meanings. One such meaning is that effective
15 competition is where there are no barriers of entry and the costs of
16 entry are not excessive. That describes the current state of the
17 telephony market in Arizona. [Teitzel Rebuttal, p. 67]
18

19 Even if the term "effective competition" doesn't appear in any Arizona rule or statute, that
20 doesn't preclude this concept from being useful. If the term "effective competition" suffers from
21 having multiple meanings, that problem is even more severe with respect to the word
22 "competition" standing alone. All real-world markets involve some degree of competition, even
23 those where a single provider serves 100% of the customers and no other providers are
24 capable of providing the service or product in question (a pure monopoly), because alternatives
25 always exist. For instance, a water utility fits the classic definition of a pure monopolist, yet it
26 faces vigorous "competition" from numerous firms selling bottled watered.

1 As I stated in my direct testimony,

2
3 Although economists recognize that full competition remains an
4 unrealized ideal in our economy, the high levels of efficiency and equity
5 achieved under effective competition have long been a primary
6 justification of America's free enterprise or market-directed system.
7 [Johnson Direct, p. 79]
8

9 I find it interesting that Mr. Teitzel attempts to invalidate my use of the term "effective
10 competition" while Mr. Shooshan employs that same term in his examination of various
11 competitive measures. [Shooshan Rebuttal, pp. 8, 24]

12 In an effort to avoid any potential ambiguities due to the fact that effective competition
13 "may have multiple meanings" I very clearly defined my use of that term in my direct testimony.
14 Namely, "Effective competition is present when a market is free of substantial barriers to entry
15 and exit and when no firm or consortium of firms has enough market power to set or strongly
16 influence market prices." [Id., p. 108] This is more stringent than Mr. Tietzel's interpretation
17 that "effective competition is where there are no barriers of entry and the costs of entry are not
18 excessive," in that the definition I offer accounts for market power, while Mr. Teitzel's does
19 not. Section four of my direct testimony demonstrates why I believe that effective competition
20 does not currently exist in telephony markets in Arizona, regardless of whether the Commission
21 uses Mr. Teitzel's looser definition, or my more stringent one.

22 In his rebuttal testimony, Mr. Shooshan disagrees with my use of concentration ratios to
23 gauge competition.
24

1 First, it is important to consider the introduction of measurement bias
2 that arises from utilization of number listings (as opposed to actual
3 usage) in measuring a concentration index. ... Using number listings or
4 lines as the appropriate measure of actual and potential *productive*
5 *capacity*—the truly economically relevant measure for gauging
6 competition—clearly understates true competitive effectiveness.
7 [Shooshan Rebuttal, p. 10]
8

9 From this testimony, I gather Mr. Shooshan disputes my emphasis on lines, and would prefer
10 more focus on usage (e.g. focusing on minutes of use or other volume-sensitive measures of
11 market share). As well, it appears he may be suggesting that a measure of the carrying capacity
12 of a network is more important than the volume of actual traffic or revenue generating services
13 that are carried over that network.

14 I disagree on both counts. In that view, if a new fiber optic network can theoretically
15 handle as much traffic as Qwest's existing network, that carrier should not be viewed as co-
16 equal with Qwest, merely because it has installed productive capacity. If it has few customers
17 and a largely empty network, this carrier's presence may be strong evidence for the existence
18 of barriers to entry that make it difficult for newcomers to convince customers to change
19 carriers. The huge volumes of empty capacity may be a better predictor of future bankruptcies
20 than a measure of current competition. In this regard, I agree with the direct testimony Qwest
21 witness Ziegler where he admonishes the Commission to recognize the "realities of the
22 competitive marketplace." [Ziegler Direct, p. 16] The empirical data that best captures the
23 extent to which competitors are successfully entering the market and winning customers (market
24 shares, 4-firm concentration ratios, and HHIs) all confirm that the "realities of the competitive
25 marketplace" are different in different parts of the state. Qwest's market power has

1 substantially diminished in some Arizona markets, but in other areas Qwest's market power
2 remains strong. Add to this fact the concern that competition may diminish in the future, due to
3 changes in the federal regulatory environment, and there is every reason to be concerned that
4 Qwest's is asking for too much freedom, too soon.

5 Finally, if Mr. Shooshan truly believed that "the elasticity of supply is the best economic
6 summary measure of competitive effectiveness," I find it interesting that not a single Qwest
7 witness has offered empirical measures of the elasticity of supply, in an effort to bolster the
8 Company's contention that it is facing effective competition. [Shooshan Rebuttal, p. 10]

9
10 **Q. Would you please outline Qwest's second critique?**

11 **A.** Yes. Mr. Shooshan responds to my contention that wireline and wireless services are not
12 competitive alternatives. He states first:

13
14 As long as the services are alike in "substance" (that is, they permit the
15 same primary function to be performed), they are comparable for
16 determining if there is effective competition. In this case, it is clear that
17 wireless and wireline service are enough alike in their primary function
18 to be considered substitutes. [Id., p. 24]
19

20 He states second:

21
22 To determine which products or services are in the same market, it is
23 not necessary for all customers to view the services as completely
24 interchangeable. Rather, services are competitive substitutes if they
25 "have the ability—actual or potential—to take significant amounts of
26 business away from each other." [Id., p. 25]
27

1 Regarding Mr. Shooshan's first point, I disagree with the notion that being alike in
2 "substance" is sufficient for two items to be classified as close substitutes. Among other
3 problems with this approach, it fails to consider the possibility that substitution may be
4 asymmetric (A is freely substituted for B but B isn't typically substituted for A). As well, it fails
5 to consider the possibility that two alternatives may perform the same substantive function, yet
6 one may be far more costly than the other. In that case, the more costly alternative doesn't
7 provide effective competition for the less costly alternative. To illustrate these complications,
8 consider again the situation where a water utility "competes" with bottled water. The
9 convenience and purity of the bottled alternative leads some consumers to purchase this
10 alternative, thereby reducing their consumption of tap water. But, due to cost differences, it is
11 hardly realistic to suggest that intense competition in the bottled water market is sufficient to
12 diminish the water utility's monopoly power.

13 I would grant that wireline and wireless phones enable the user to place phone calls.
14 They are alike in this manner. However, in my direct testimony, I offered nine ways in which
15 wireline and wireless are quite different. [Johnson Direct, pp. 178-179] Additionally, I have
16 offered evidence that most consumers seem to believe that they are not close substitutes.
17 Among other things, this is proven by the fact that so many consumers add wireless service
18 without simultaneously dropping their wireline service. [Id., p. 179] Aside from introducing the
19 "substance" concept, Mr. Shooshan has not offered any empirical "substance" to his rejection
20 of my conclusions about wireless service.

21 I addressed Mr. Shooshan's second point in my direct testimony. Recall I mentioned
22 that "wireless services do not constrain Qwest's ability to exploit its monopoly power in

1 traditional wireline markets.” [Id.] I have shown that wireless service has not *actually* taken
2 much business away from Qwest and any *potential* ability to do so is so speculative that it does
3 not justify immediate action to adopt the sweeping revisions Qwest has proposed for its current
4 Plan.

5 While Qwest did not provide much numerical evidence in its direct testimonies to
6 support its wireless substitutability claims, one exception is the data cited by Mr. Teitzel in his
7 rebuttal testimony. Interestingly, this data serves to validate my position on this issue rather than
8 Qwest's. Recall that in my direct testimony I stated:

9
10 For many customers, these services more closely meet the definition of
11 complementary goods, rather than substitutes. Most people purchase
12 both services, using their mobile phone in situations where it will
13 function best and their conventional phone where it will function best.
14 The very fact that so many people keep both phones (even if it requires
15 them to double their expenditure on phone service) tends to prove that
16 these services should not primarily be viewed as competitive
17 alternatives. [Johnson Direct, p. 137]
18

19 In my direct testimony, I recognized that approximately 6% of wireless customers have
20 abandoned their wireline service entirely. [Teitzel Rebuttal, p. 69] Mr. Teitzel goes on to
21 reference a Yankee Group study that shows 64% of U.S. households have both a wireless and
22 a wireline phone. [Id., p. 70] This dynamic – in which significantly more people have both
23 phones than have substituted one for the other – reasonably supports the conclusion that these
24 two services are primarily complements, rather than substitutes.

25 Finally, Mr. Teitzel critiques my assessment of cable telephony and VoIP as being “in
26 their infancy.” [Johnson Direct, p. 179] He mentions that Cox – a cable telephony provider – is

1 a "very robust telecommunications competitor" and that VoIP is a "viable telecommunications
2 alternative." [Teitzel Rebuttal, p. 71] I am unsure how closely Mr. Teitzel read my direct
3 testimony because I refer to these technologies as "potentially much more direct substitutes for
4 traditional telephony" and I include Cox lines in my HHI calculations. [Johnson Direct, p. 179] I
5 recognize the potential for increased substitution by these technologies, but even after giving full
6 weight to lines provided by the most significant local provider (Cox), I still concluded that only
7 some portions of Qwest's serving area had enough competition to justify the pricing flexibility
8 the Company is seeking.

9
10 **Q. What type of pricing flexibility is the Company seeking?**

11 **A.** As I stated in my direct testimony,

12
13 The current Plan includes a number of provisions that limit the extent to
14 which the Company can increase rates for services in each of the
15 current Plan's three baskets. The "inflation minus productivity" indexing
16 mechanism, hard service caps, and rate element cap in Basket 1 are all
17 examples of existing provisions that limit the Company's pricing-
18 flexibility. These specific provisions and others would be modified in the
19 proposed Plan, thereby providing greater opportunities to charge higher
20 prices to all the Categories. [Id., p. 19]
21

22 Additionally, Qwest has proposed nearly complete pricing freedom for services in its proposed
23 Flexibly-priced Competitive Services basket. And its proposed "competitive zone" approach
24 would allow it to move services from the Basic basket into the Flexibly-priced basket in certain
25 portions of its Arizona serving area.
26

1 **Q. Having already stated that your analysis of competition in Arizona indicated little**
2 **support for the flexibility sought in Qwest's proposed Plan, do you support an**
3 **alternative Plan?**

4 A. Yes. I urge the Commission to utilize RUCO's recommended Plan to regulate Qwest services
5 going forward.

6
7 **Q. Did Qwest argue against the utilization of the recommended Plan in its rebuttal**
8 **testimony?**

9 A. Yes. Mr. Teitzel and Mr. Shooshan addressed perceived flaws in the recommended Plan. The
10 witnesses critique the assignment of services to baskets as well as the retention of the
11 productivity offset in the basket-wide cap on Basic Services. Regarding basket assignment,
12 Mr. Shooshan argued that the recommended Plan was flawed in that it (1) doesn't keep
13 wholesale services and retail services in separate baskets, (2) is contrary to spirit of price cap
14 regulation, and (3) is too complex and cumbersome. Mr. Teitzel similarly argues that the
15 recommended Plan "is perhaps interesting as an academic exercise but is impossible to
16 effectuate." [Teitzel Rebuttal, p. 68]

17 Regarding the productivity offset, Mr. Shooshan contends (1) that it is not consistent
18 with evolution of price cap regulation, (2) that other states have abandoned it, and (3) that it is
19 wrong to use nationwide data in calculating it.

1 **Q. Would you like to address Qwest's points pertaining to basket assignment under the**
2 **recommended Plan?**

3 A. Yes. I would first like to point out that Qwest has not questioned the validity of using
4 competitive intensity to assign services. In fact, with respect to this underlying principle,
5 RUCO's recommended Plan is very similar to Qwest's competitive zone approach. As a
6 matter of pure logic, it is obviously appropriate to tailor the degree of pricing flexibility to with
7 the intensity of the competitive pressures that Qwest faces. Because I believe that this
8 fundamental logic applies to all price capped services, I don't think it is necessary to keep
9 wholesale and retail services in separate baskets. What is important is to make sure that the
10 most competitive services aren't commingled with the least competitive services. Mr.
11 Shooshan simply states that separation of wholesale and retail services represents a
12 "progressive approach," but he doesn't provide any support for this opinion. [Shooshan
13 Rebuttal, p. 6] If he is concerned that competitive retail services might be placed in the same
14 basket with monopoly wholesale services, I would certainly share that concern. If it is
15 necessary to create additional baskets to avoid this possibility, I would not necessarily object to
16 doing that.

17 While I am unsure what Mr. Shooshan means by the "spirit of price cap regulation,"
18 perhaps I touched on this subject in my direct testimony, where I stated:

19 The specific goal of price cap regulation is to eliminate, or at least
20 weaken, the linkage between cost and rates, but there is no evidence
21 that policy makers have abandoned their focus on the broad public
22 interest, or that they are no longer concerned about the traditional goals
23 of public utility regulation. For example, in developing and refining its
24

1 system of price cap regulation, the FCC apparently still viewed the
2 results of effective competition as an appropriate benchmark for price
3 cap regulation. [Johnson Direct, p. 83]
4

5 I do not see any way in which the recommended Plan abandons any of these principles. It is
6 my view that assigning services to baskets according to competitive intensity will advance the
7 public interest because price controls will be loosened most for services and areas with the
8 most intense competition and controls will be only moderately relaxed, or maintained, for
9 services and areas with less intensive competition.

10 Regarding Qwest's concerns with the complexity of service assignment under the
11 recommended Plan, I conceded in my direct testimony that RUCO's approach was "somewhat
12 more complex" than Qwest's competitive zone approach. [Id., p. 171] Qwest claims that
13 instead of being *somewhat* more complex, RUCO's approach is *much* more complex.
14 [Shooshan Rebuttal, p. 7] I strongly dispute this difference in degree. But, even if a more
15 precise alignment of services and geographic areas *were* much more complex, that added
16 complexity is fully justified if the Commission wants to grant Qwest as much pricing flexibility as
17 possible, while making certain that the public interest is protected.

18 The appropriate assignment of services to baskets is crucial in price regulation. This
19 assignment process dictates the degree of pricing flexibility that Qwest will be afforded in each
20 case. If this assignment process is overly simplistic, Qwest may be granted an excessive degree
21 of pricing flexibility in markets where it faces relatively little competitive pressure, and thus it will
22 be able to exploit its residual market power to the detriment of its customers and the public
23 generally. In my direct testimony, I specifically cautioned the Commission concerning this risk

1 due to the excessive simplicity of Qwest's proposed approach. [Johnson Direct, p. 171]

2 The current standards for classifying services as competitive can be found in
3 Commission Rule R14-2-1108B.

4 The petition for competitive classification shall set forth the conditions
5 within the relevant market that demonstrate that the telecommunications
6 service is competitive, providing, at a minimum, the following
7 information:
8

- 9
- 10 1. A description of the general economic conditions that exist
11 which make the relevant market for the service one that is
12 competitive;
 - 13 2. The number of alternative providers of the service;
 - 14 3. The estimated market share held by each alternative provider of
15 the service;
 - 16 4. The names and addresses of any alternative providers of the
17 service that are also affiliates of the telecommunications
18 company, as defined in R14-2-801;
 - 19 5. The ability of alternative providers to make functionally
20 equivalent or substitute services readily available at competitive
21 rates, terms, and conditions; and
 - 22 6. Other indicators of market power, which may include growth
23 and shifts in market share, ease of entry and exit, and any
24 affiliation between and among alternative providers of the
25 service(s). [R14-2-1108B]
26

27 The approach to basket assignment found in the recommended Plan is consistent with the
28 procedure that Qwest must currently undertake to classify its services as competitive – taking
29 into account the number of competitors, market shares, and other measures of market power.
30 There is nothing about the current competitive classification mechanism that is unduly complex
31 or burdensome.

1 To the extent service assignments under RUCO's recommended Plan would be more
2 complex, that is primarily due to the fact that three categories would be used in evaluating the
3 degree of competition, rather than two categories (competitive or not), and because Qwest
4 would have the option of requesting different classification of the same service in different
5 geographic markets. Admittedly, the latter option does add to the overall complexity of the
6 system, but that same complexity is inherent in Qwest's own competitive zone proposal.

7 Furthermore, I would note that the same types of empirical evidence which are
8 envisioned in the existing Rule (e.g. market shares) are often available for individual wire centers
9 or exchanges.

10 Finally, it is not clear whether any "services that are deregulated today" would be "re-
11 regulated when they are passed through Dr. Johnson's screen." At most, perhaps some
12 services that have been placed into the most flexible pricing category should more appropriately
13 be placed in the middle category, where Qwest would still enjoy a very substantial degree of
14 pricing freedom. Such a reclassification would not be unreasonable, and in fact is contemplated
15 under the current Commission rules:

16 Any telecommunications service classified by the Commission as
17 competitive may subsequently be reclassified as noncompetitive if the
18 Commission determines that reclassification would protect the public
19 interest. Notice and hearing would be required prior to any
20 reclassification. The burden of proof would be on the party seeking
21 reclassification. [R14-2-1108H]
22
23
24
25

1 **Q. Dr. Johnson, in your direct testimony you summarized some competition statistics**
2 **gathered from the June 30, 2004 edition of FCC Local Competition Report (FCC**
3 **LCR). What does the December 2004 update of the FCC LCR indicate about the**
4 **overall level of competition in Arizona?**

5 **A. According to the most recent FCC LCR, the overall CLEC market share in Arizona increased**
6 **from 21.8% as of December 2003 to 25.2% as of June 30, 2004. [Table 6, FCC LCR] This**
7 **is roughly five times the CLEC market share of 5% reported by the FCC in June 2000 [Table**
8 **7, FCC LCR]. This recent surge in CLEC market presence is consistent with the recent trend**
9 **nationally; the nationwide CLEC market share more than quadrupled from December 1999 to**
10 **June 2004 (from 4% to 18%). Table 1 below shows how Arizona compares to the other**
11 **Qwest states and the nationwide totals, as of June 2004. These data suggest that competition in**
12 **Arizona is similar to the level of competition that is present in Minnesota, Nebraska and Utah.**
13 **Competition in the remaining Qwest states appears to be substantially less well developed.**

Table 1
End-User Switched Access Lines
in States Served by Qwest
(As of June 30, 2004 per FCC LCR)

State	ILECs	CLECs	Total	CLEC Share
Arizona	2,415,432	814,194	3,229,626	25.2%
Colorado	2,439,132	498,583	2,937,715	17.0%
Idaho	666,914	47,398	714,312	6.6%
Iowa	1,232,364	199,115	1,431,479	13.9%
Minnesota	2,377,827	604,152	2,981,979	20.3%
Montana	482,548	19,204	501,752	3.8%
Nebraska	736,257	205,560	941,817	21.8%
New Mexico	894,345	76,469	970,814	7.9%
North Dakota	265,881	22,502	288,383	7.8%
Oregon	1,743,918	267,121	2,011,039	13.3%
South Dakota	271,682	n/a	n/a	n/a
Utah	940,678	288,009	1,228,687	23.4%
Washington	3,276,000	494,375	3,770,375	13.1%
Wyoming	235,360	n/a	n/a	n/a
Total Qwest	17,978,338	3,536,682	21,007,978	16.8%
Total Qwest w/o AZ	15,562,906	2,722,488	17,778,352	15.3%
Nationwide	148,103,506	31,983,229	180,086,735	17.8%

1 **Q. Has the provisioning composition of the roughly 25% CLEC market share in Arizona**
2 **changed with the update?**

3 A. No it has not. Table 10 of the FCC LCR shows that 50% of the CLEC lines in Arizona are
4 purely facilities-based (using loops that are self-provided) and 33% are UNE-based (including
5 both UNE-P and UNE-L). This is about the same relative composition reported 6 months
6 earlier.

7
8 **Q. How does this competitive mix compare to other Qwest states?**

9 A. Table 2 below provides this comparison. With respect to facilities-based competition, Arizona
10 represents over 34% of facilities based lines in Qwest's 14 state territory.

Table 2
CLEC-Reported End-User Switched Access Lines By State
(As of June 30, 2004 per FCC LCR)

State	CLEC-Owned (%)	UNEs (%)	Resold Lines (%)
Arizona	50	33	17
Colorado	31	47	22
Idaho	n/a	55	n/a
Iowa	20	72	8
Minnesota	28	51	21
Mississippi	4	74	22
Montana	77	n/a	n/a
Nebraska	66	21	14
North Dakota	34	n/a	n/a
Oregon	13	71	16
South Dakota	n/a	n/a	n/a
Utah	24	49	27
Washington	30	52	18
Wyoming	n/a	n/a	n/a
Total Qwest	33	48	18
Total w/o AZ	28	52	19
Nationwide	23	61	16

1 **Q. Can market share data be useful to the Commission in deciding how much pricing**
2 **flexibility to grant Qwest through revisions to its Plan?**

3 A. Yes. There are at least two ways in which market share data can be useful to the Commission.
4 First, this data is useful in evaluating the extent and degree to which competitors are succeeding
5 in their efforts to enter Qwest's markets. Recall, in my direct testimony, I stated:

6
7 Market dominance and the ability to exercise market power – not the
8 mere presence of alternative suppliers – are the key issues in deciding
9 whether effective competition has emerged or is emerging. Thus, a
10 logical first step in evaluating the extent of competition is to evaluate
11 relative market shares. If the incumbent continues to enjoy an
12 overwhelmingly large market share relative to the new entrants, it would
13 not be appropriate to adopt regulatory policies which assume that
14 competition is effective. Unless and until the incumbent's market power
15 is greatly eroded, the continued regulatory oversight provided by state
16 commissions and the FCC provides valuable protection for consumers
17 and the public interest generally. [Johnson Direct, pp. 112]
18

19 Based upon market share data, I reached the following conclusions regarding wireline
20 competition in Arizona.

21
22 In general, CLEC market shares in Arizona are

- 23
24 - higher for services to businesses than services to residences;
25 - higher for services in metropolitan markets than in rural areas;
26 and
27 - are held almost entirely by carriers that use their own facilities at

1 least in part.

2
3 **Q. What is the second useful aspect of these market share data?**

4 **A.** These data not only reflect the extent to which the Arizona telecommunications market is
5 competitive, it also examines the underlying composition of that competition. For instance,
6 Arizona CLECs utilize UNEs in providing ****Proprietary Proprietary**** of their lines;
7 they fully rely on their own facilities for ****Proprietary Proprietary**** of their lines, and
8 they rely on pure resale for just ****Proprietary Proprietary**** of their lines.

9 This data is significant, since these different methods of operation have varying
10 implications for the likely outcome if Qwest were given additional pricing freedom. Simply
11 stated, facilities-based carriers face more substantial barriers to entry and exit than carriers that
12 strictly rely on resale of Qwest's services and/or network elements. Facilities-based CLECs
13 are more independent of Qwest, but they make a larger capital investment; the added risks
14 associated with these sunk investments may encourage facilities-based CLECs to be "price
15 followers" who are reluctant to "rock the boat." Conversely, CLECs that rely on UNE-P and
16 pure resale will encounter lower barriers to entry and exit, but they are less capable of acting
17 independently from Qwest (e.g., they cannot easily compete by adopting and promoting a
18 newer technology).

19 Another important factor to consider in light of the fact that Arizona CLECs utilize UNE
20 switching to provide ****Proprietary Proprietary**** of their lines is the ongoing
21 advocacy by Qwest at the federal level:
22

1 Qwest and the other RBOCs have been actively lobbying to restrict the
2 availability of UNEs and to make it more difficult, or impossible, for
3 CLECs to rely exclusively on this form of entry. [Johnson Direct, pp.
4 122]

5
6 Depending upon the content of these revised rules, much of the
7 competitive activity that is currently observed, based upon rental of
8 UNEs, may disappear. While this may result in more facilities-based
9 competition, the latter form of competition is clearly more difficult and
10 time consuming to achieve; thus the overall level of CLEC market
11 penetration may decline below current levels, and it may remain at
12 relatively low levels for many years into the future. [Johnson Direct, pp.
13 124]
14

15 Many CLECs are dependent on the use of unbundled portions of Qwest's network in its
16 Arizona serving area. The existing degree of "successful entry" is not necessarily indicative of
17 what the future holds, particularly if the unbundling requirements are loosened, due to the
18 advocacy efforts of Qwest and other ILECs.
19

20 **Q. How should the Commission interpret market share data?**

21 A. All of these statistics indicate that, almost without regard to where in Qwest's serving territory
22 you focus your attention, the market for residential local exchange service remains "highly
23 concentrated." Recall that in my direct testimony, I provided the Commission with some
24 benchmarks that it could use in evaluating the degree of pricing flexibility which should be
25 associated with specific services and geographic markets. In an effort to provide some
26 benchmarks for judging market conditions, I mentioned that I would anticipate that if the
27 ILEC's market share remains in excess of 67%, it most likely should only receive moderate

1 pricing flexibility. Similarly, if the service is provided in a market with a 4-firm concentration
2 ratio in excess of 90% and an HHI in excess of 4,000, most likely it would not be appropriate
3 to grant more than moderate pricing flexibility to the ILEC.

4 An ILEC market share between 67% and 33%, a 4-firm concentration ratio between
5 90% and 75%, and/or an HHI between 4,000 and 1,800 would be indicative of a somewhat
6 more intensely competitive market—one where regulatory controls could reasonably be relaxed
7 to a greater degree, but significant regulatory protections should remain in place.

8 Finally, I suggested it would be reasonable to grant total pricing flexibility (with
9 essentially no continuing regulatory protection from monopoly power) if the dominant carrier
10 has a market share of 33% or lower, and the market exhibits a 4-firm concentration ratio that is
11 lower than 75%, or an HHI of 1,800 or less.

12 Applying these benchmarks to the data received via discovery, we note that Qwest's
13 share of the residential local exchange service market exceeds 67% in all but two of its wire
14 centers. Similarly, the 4-firm concentration ratio in each Qwest wire center exceeds 90%.
15 And finally, the residential HHIs in each Qwest wire center exceed 4,000 in all but the same
16 two wire centers. These data are consistent with the general conclusion that CLEC market
17 shares tend to be higher for services in metropolitan markets than in rural areas. Hence, it is not
18 surprising that the two wire centers with residential market shares below 67% and residential
19 HHIs below 4,000 are ****Proprietary Proprietary****.

20 As I discuss more thoroughly in the following section, the evidence indicates that it
21 might be appropriate for the Commission to keep most of residential local exchange service in
22 the most tightly regulated service category (e.g., the Moderate Basket in RUCO's

recommended plan). The only exception would be the aforementioned wire centers.

Q. In your direct testimony you provided some illustrative examples of how the Commission might go about assigning specific services to baskets. Mr. Shooshan implies that under RUCO's recommended Plan the assignment process will be too complex. Can you provide some illustrative examples that clarify your recommendations, and demonstrate that it is not impossibly complex?

A. Yes. Schedules 1 and 2 attached to this testimony contain Qwest market share data and 4-firm concentration ratios, as well as HHIs by Qwest wire center, for residential local exchange service and business local exchange service, respectively. These data were provided as Schedules 4 and 5 in my direct testimony. To illustrate the assignment process, I have added recommendations for assigning these services by wire center to the three baskets in RUCO's recommended Plan in the final column of the schedules I present here.

Q. Would you please present your analysis of residential local exchange service?

A. Yes. Recall there are three attributes that can be used to assign a service to a basket under the RUCO's recommended Plan – geography, customer type, and service-specific characteristics.

Schedule 1 takes into consideration all three attributes. Residential local exchange services provide local calling capability, as well as providing access to a variety of other services, including switched toll services, custom calling services and caller ID. By looking at market data for residential customers separately from business customers, we are able to consider competitive differences related to customer type. By looking at market data for each

1 individual wire center we are able to consider competitive differences within distinct geographic
2 areas.

3 By and large, the data in Schedule 1 suggests that competition is more extensive in
4 highly urbanized areas than in outlying areas; this is not unexpected, considering differences in
5 the concentration of customers and other factors. For example, the relatively dense Phoenix-
6 Main wire center has an HHI of ****Proprietary Proprietary****. In contrast, the
7 Whitlow wire center has a much lower density, and an HHI of ****Proprietary**
8 **Proprietary****.

9 By closely examining the data in Schedule 1, however, it is clear that other geographic
10 factors are at work, in addition to differences in density. As well, it becomes clear that
11 residential competition is still relatively weak in comparison with business competition. In fact,
12 all but two of Qwest's wire centers exhibit residential HHIs that exceed the 4,000 benchmark
13 that I suggested as a potential benchmark for delineating between the Moderate Pricing
14 Flexibility basket and the High Pricing Flexibility basket.

15 Given current market conditions and uncertainties concerning future trends in
16 competition, RUCO recommends that residential local exchange services be placed in the
17 Moderate Pricing Flexibility basket within all wire centers except for Phoenix - Main and
18 Tucson - Main. Within these two wire centers, residential local services should initially be
19 placed in the High Pricing Flexibility basket. Once experience has been gained with the impact
20 of this reassignment, it would be reasonable to consider a request for movement into the Total
21 Pricing Flexibility basket. I will explain the rational for this as I describe the next illustrative
22 example.

A. Yes. Recall that my Schedule 2, attached to this testimony, contains competitive data for business local exchange service in each Qwest wire center. In the ****Proprietary**

Q. Up to this point in your discussion, all business local exchange services have been lumped together. Is it feasible to account for the differences in the various business services?

A. Yes. However, the Commission would need to make some judgment calls, because the data provided during discovery is relatively weak in this regard. As I mentioned on page 175 of my direct testimony

1 there are most likely differences in the intensity of competition for
2 various business services, including 1FB, PBX trunks, and Centrex. In
3 general, I would anticipate greater competitive penetration for PBX
4 trunk service than for 1FB service, and greater competition for Centrex
5 than for PBX trunk service. However, due to data limitations I was not
6 able to compute separate HHIs for each of these services. [Johnson
7 Direct, p. 175]
8

9 Given the available evidence, it would be reasonable, for example, for the Commission
10 to place PBX Trunks and Centrex service in the ****Proprietary**
11 **Proprietary**** in the Total Pricing Flexibility basket, while placing 1FB service in the High
12 Pricing Flexibility basket.
13

14 **Q. How do your illustrative examples compare to the assignment of services to baskets**
15 **under Qwest's proposed Plan?**

16 **A.** Recall that the proposed Plan assigns services to three baskets – Basic/Essential Non-
17 competitive Services and Flexibly-priced Competitive Services (Wholesale Services basket is
18 the third basket). Under Qwest's competitive zone proposals, many local exchange services
19 would be assigned to the Flexibly-priced Competitive Services basket, and thus virtually all
20 protection from monopoly power would be eliminated.

21 The major differences between RUCO's recommend Plan and Qwest's proposal are
22 that RUCO provides a middle basket, which affords more pricing flexibility than the existing
23 plan, but less than total flexibility. As shown on Schedule 2, this middle ground is very
24 important under current market conditions. RUCO recommends assigning business local
25 exchange service in many geographic areas to this middle basket, because competition has

1 advanced substantially, but not enough to justify granting total pricing flexibility.

2 Finally, RUCO recognizes that competition for many of the services used by large
3 businesses is already very robust. Accordingly, RUCO recommends placing these services into
4 the Total Pricing Flexibility basket, which is very similar to the Company's proposed Flexibly-
5 priced Competitive Services basket. If the Commission adopts this recommendation, the
6 Company will have nearly complete freedom to price these services in whatever manner it
7 chooses.

8
9 **Q. Would you like to address Qwest's points pertaining to the inclusion of a productivity**
10 **offset (X) under the recommended Plan?**

11 **A.** Yes. Mr. Shooshan suggests that the use of an offset is not consistent with the evolution of
12 price cap regulation *because* many state commissions have recently approved Plans devoid of
13 an offset. I cannot speak to the evidentiary record or advocacy context in which the decisions
14 were made in Iowa, Colorado and Minnesota to eliminate use of an offset. However, simply
15 citing to decisions in other jurisdictions is not an appropriate basis for making a decision that
16 could result in a shift of many hundreds of millions of dollars from Arizona customers to
17 Qwest's stockholders for the next 20 years. The evidence I presented in my direct testimony
18 demonstrated that the existing 4.2% offset continues to be consistent with annual productivity
19 and input cost savings achieved by the industry from 1986 to the present.

20 I explained the rationale for adjusting inflation for industry-specific productivity and cost
21 reductions in my direct testimony:

1 ...price cap regulation generally focuses on industry-wide data, while
2 traditional regulation focuses on carrier-specific data. However, the full
3 impact of this difference is not felt initially. When a price cap system is
4 initially instituted, it typically resembles traditional regulation, since the
5 price cap is usually based upon the existing tariffs, which were derived
6 from carrier-specific data. ...Over time, the two systems will tend to
7 diverge, since the price cap method of regulation normally focuses on
8 industry-wide factors, while traditional regulation focuses on company-
9 specific data (in a rate case). ...

10
11 By including a factor for inflation, the firm is allowed to increase its
12 prices to keep pace with inflation. This makes sense, to the extent that a
13 firm's costs can be expected to increase as a result of inflation.
14 However, since costs do not increase by exactly the same amount
15 throughout the economy, due, for example, to industry-specific
16 differences in productivity growth, the formula typically includes a factor
17 (usually referred to as the "X" factor) which attempts to track industry-
18 specific differences. [Id., pp. 84, 85]
19

20 Looking at national data, it is clear that ILECs continue to benefit from cost reductions relative
21 to the overall rate of inflation. In other words, an ILEC of ordinary efficiency can still expect to
22 benefit from windfall profits if it is allowed to increase its rates in synch with the national inflation
23 rate, without taking into account the more favorable trends in productivity and input costs being
24 experienced by the telecommunications industry. Costs are not increasing as fast as the overall
25 inflation rate.

26 In this regard, it is important to focus on national data, rather than exclusively focusing
27 on state-specific or carrier-specific data. While the latter data might suggest a recent
28 diminishment in the long term decline in real telecommunications costs, that data is too narrow
29 to provide an accurate, reliable indication of underlying cost conditions. Furthermore, an

1 exclusive focus on state-specific or carrier-specific data will tend to reestablish a direct link
2 between Qwest's costs and its rates (albeit after a lag), thereby diluting incentives for increased
3 efficiency and cost minimization.

4 Because the traditional system of rate base regulation relies upon carrier-specific cost
5 information (albeit after a lag), there is a direct link between management decisions and prices
6 that can weaken the incentive for firms to operate efficiently (e.g., because inefficiencies and
7 excessive costs may be recovered from customers).

8 With a price cap system, prices are regulated by focusing on the changes in the overall
9 level of costs that the firm faces (input cost inflation), and subtracting the impact of productivity
10 or expected productivity growth as it can generally be expected to impact firms in the industry.
11 The price cap should rise if the prices of a firm's inputs rise, but it should not be linked directly
12 to changes in the specific costs incurred by each individual firm. If the system is tied to industry-
13 wide data, it is feasible to avoid a direct link between management inefficiency and higher
14 prices. Thus, by relying on broad data sets, management will have strong incentives to minimize
15 the prices it pays for its inputs, and strong incentives to increase its productivity as much as
16 possible. Whenever management reduces costs, the benefits will immediately and directly flow
17 to stockholders (since revenues and the price cap remain unchanged). The same can be said
18 about traditional regulation between rate cases; however, when a rate case does occur,
19 efficiency incentives are diluted, because observed cost reductions are eventually passed
20 through to ratepayers. In contrast, the benefit of industry wide declining costs should be passed
21 through to customers. A properly designed price cap formula, which includes an appropriate
22 offset based on industry data will assure strong incentives for efficiency and fair treatment of

1 customers. To the extent cost reductions are generic to the industry, they will be reflected in the
2 data that is used in the price cap formula, and the benefits of these cost reductions will be
3 shared with customers.

4 Thus, a price cap system with an appropriate offset provides stronger, more lasting
5 incentives for management to cut costs and increase efficiency, in comparison with a scenario in
6 which no offset is used, a scenario in which there are frequent rate cases, or a scenario in which
7 the Commission relies on an ever-present threat of rolling back rates if excess profits arise due
8 to a failure to include an offset in the price cap system.

9
10 **Q. Would you like to address any other points raised in Qwest's rebuttal testimonies?**

11 **A.** Yes. Mr. Teitzel, in his rebuttal testimony, critiques the revenue-cost comparisons I included
12 on pages 46 through 63 of my direct testimony. He makes the following statements:

13
14 As discussed in Ms. Million's direct testimony, Qwest's revenues are
15 deficient by approximately \$64 million to cover the cost of providing
16 local exchange service in high cost wire centers. This was the basis for
17 Qwest's proposal to establish a competitively-neutral draw from the
18 AUSF to support the provision of local exchange service to high cost
19 areas. [Teitzel Rebuttal, p. 65]

20
21 However, the revenue generated by customers in the highest cost wire
22 centers is not sufficient to cover Qwest's costs of providing service to
23 those customers. This fact is the driver of Qwest's AUSF proposal.
24 Essentially, Dr. Johnson is suggesting that the monopoly era system of
25 implicit subsidies should be continued in perpetuity in Arizona. [Id., pp.
26 66-67]

27
28 Mr. Teitzel contends that Qwest's revenues in high cost areas are deficient by \$64 million

1 based upon an analysis of the cost of providing local exchange service in these areas. While I
2 don't disagree with the premise that it costs more to provide service in some areas relative to
3 others, I strongly dispute the specific method Qwest is using to estimate the magnitude of the
4 alleged shortfall. Recall that I stated the following in my direct testimony:

5
6 Having been active in utility regulation for more than 25 years, I have
7 been a part of numerous proceedings in which subsidy claims are made.
8 I have found that where differences of opinion exist concerning the
9 presence or absence of cross subsidies, the debate almost always
10 centers around a single major point of contention—the appropriate
11 interpretation and treatment of joint and common costs. [Johnson
12 Direct, p. 48]
13

14 Staff witness Regan provided testimony that confirms the crucial importance of the appropriate
15 treatment of joint and common costs in this context:

16
17 Qwest would already be incurring the costs of the loops and ports if
18 Qwest was "already" providing toll, access and vertical services, so
19 those costs are not "additional" costs of basic local exchange service.
20 However Qwest improperly included 100% of these loop and port
21 costs in its claimed basic local TSLRIC. [Regan Direct, p. 16]
22

23 My revenue-cost comparisons show that the problem is not as widespread, or as severe, as
24 Mr. Teitzel contends. Qwest did not provide a substantive response to my quantitative analysis
25 in its rebuttal.

26 With regard to Mr. Teitzel's contention that "the monopoly era system of implicit
27 subsidies should be continued in perpetuity in Arizona" this is simply not true. To the contrary,
28 my revenue-cost comparisons suggest there are significant discrepancies in Qwest's gross profit

1 margins across different geographic markets. While I don't necessarily agree with
2 characterizing these discrepancies as "implicit subsidies" I agree there is reason to be
3 concerned about the magnitude of these discrepancies. Over the long term, these discrepancies
4 may not be sustainable, given the increased level of competition being experienced in urban
5 markets relative to rural markets – as well as the higher level of competition being experienced
6 in business markets where the largest gross margins have historically been achieved. If profit
7 margins continue to erode in these markets, it may be difficult for Qwest to continue to
8 profitably serve low margin customers in high cost markets. As well, there is reason to be
9 concerned that these discrepancies in gross profit margins have a tendency to distort the price
10 signals that are sent to other carriers, by discouraging them from attempting to compete with
11 Qwest in high cost areas.

12 Not only do I share some of Qwest's concerns about continuation of the status quo, I
13 specifically recommended that, to the extent that Qwest believes it needs changes in the
14 regulatory environment in order to "recover its costs of serving customers in high cost areas," I
15 recommend utilizing a state Universal Service Fund approach similar to the one used in Kansas.
16 [Ziegler Direct, p. 8]

17
18 The KCC initially established the Kansas Universal Service Fund as a
19 "revenue neutral" mechanism which replaced a portion of the existing
20 access revenues. It later replaced this system with a forward-looking
21 cost-based mechanism. The KCC recognized that costs per line can
22 vary widely with density and distance from the central office. Therefore,
23 in order to take these factors into account, the KCC decided to target
24 support on the highest cost (i.e., least dense, most distant) areas within
25 each wire center. Wire centers and zones within these wire centers
26 were not given support unless the relevant costs per line exceeded

1 125% of the statewide average costs per line. [Johnson Direct, p. 65]
2

3 **Other Intervenor**
4

5 **Q. Would you like to address any of the points raised in the direct testimonies of the**
6 **other intervenors in these proceedings?**

7 **A. Yes. In particular, I would like to respond to two areas in which other intervenors put forward**
8 **positions that are contrary to my recommendations – suggestions for modifying the current Plan,**
9 **and suggestions for lowering switched access rates.**
10

11 **Q. Would you please outline and respond to intervenor positions as they relate to the first**
12 **issue?**

13 **A. Yes. No other witness has recommended departing from the existing basket structure found in**
14 **the current Plan. Those that have made suggestions for modifying the current Plan have limited**
15 **their comments to suggestions for tweaking the existing price caps or the existing reclassification**
16 **mechanism. I agree the current Plan is basically sound, and it would be better to retain the**
17 **current Plan than to adopt Qwest's proposed Plan, I believe that now is an appropriate time to**
18 **rethink the current Plan's basket structure, and to modify that structure, in order to provide**
19 **Qwest with some additional pricing flexibility on a highly targeted basis, without prematurely**
20 **removing protection from monopoly power in those markets where Qwest continues to enjoy a**
21 **substantial degree of market power.**

22 Second, I take issue with Staff's and DoD's proposed price caps. Like Qwest, Staff

1 supports eliminating X and replacing it with a revenue cap. Unlike Qwest, Staff proposes to
2 retain a revenue cap on the Competitive Services basket. In responding to Qwest arguments
3 above, I reemphasized why I believe it is appropriate to retain an offset. Neither Qwest nor
4 Staff have presented any substantial evidence that the decades-long pattern of declining real
5 costs in the telecommunications industry has suddenly come to a halt, or that market forces
6 alone are capable of passing through to consumers the benefits of increasing productivity and
7 declining costs, similar to the manner in which these benefits flow to consumers under
8 conditions of effective competition.

9 I find it puzzling that Staff would paint a rather bleak picture of competition in Arizona,
10 and yet contend that lost productivity due to "line and revenue losses" justify eliminating the
11 offset. [Rowell Direct, p. 13] The effect of eliminating the offset will be to give Qwest an
12 opportunity to earn monopoly profits from services sold in those markets where it faces the
13 weakest competition.

14 On the other hand, I believe Staff goes too far in the opposite direction (i.e., not
15 granting Qwest sufficient pricing flexibility) when it proposes using a revenue cap in the
16 Competitive Services basket, even with an upward adjustment. [Rowell Direct, p. 12-13] I
17 agree with Qwest's contention that competition is robust for some of its services in portions of
18 its Arizona serving area. [Johnson Direct, p. 176] Given this fact, it can be reasonably expected
19 that market forces alone will force Qwest to pass productivity gains and cost reductions through
20 to consumers in these areas. As a result, I support RUCO's conclusion that the maximum rate
21 provisions in Commission rules A.A.C. R14-2-1109 and A.A.C. R14-2-1110 are sufficient
22 price caps on Competitive Services. I see no reason to impose a revenue cap, nor do I

1 anticipate any problem with granting Qwest near total pricing flexibility in these specific
2 markets.

3
4 **Q. Have any other intervenors proposed modifying the competitive zone approach Qwest**
5 **employs in its proposed Plan?**

6 A. Yes. Staff and Cox present their own competitive zone proposals. In one respect their
7 recommendations are consistent with RUCO's recommended Plan: they separately deal with
8 residential and business services. [See, Rowell Direct, p. 42 and Lee Direct, p. 9]

9 In another respect they take a quite different approach: Staff witness Rowell and Cox
10 witness Lafferty argue against the use of Qwest wire centers as the geographical basis for
11 competitive zones. Mr. Rowell states:

12 The disadvantages of the wire center are that listing information is not
13 available at the wire center level, information on CLECs who use their
14 own network exclusively is not available at the wire center level (but
15 Qwest has provided problematic estimates), information on wireless
16 carriers and VOIP providers is not available at the wire center level and
17 customers are not familiar with the concept of a wire center. [Rowell
18 Direct, p. 24]
19
20

21 Mr. Lafferty states:

22 Both customers and competitors must have a clear understanding of the
23 boundaries. Customers think in terms of town, cities, counties and
24 states, so any other definition would be hard for them to grasp. ... Most
25 customers would understand towns or exchanges, but not wire centers.
26 [Lafferty Direct, pp. 29-30]
27
28

1 After carefully considering the arguments proffered by Staff and Cox against the use of wire
2 centers as a basis for evaluating competition, I continue to believe it is useful to analyze the data
3 on this basis.

4 The first, most important advantage of using wire centers is that robust data is readily
5 available for individual wire centers. Mr. Rowell concedes this point.

6 Certain facts are available at the wire center level. The number of
7 competitors serving customers in a wire center through UNE-L,
8 UNE-P, and resale is known to Qwest. Also the specific number of
9 lines each such competitor is serving in a wire center is known to
10 Qwest. [Rowell Direct, p. 24]
11
12

13 It is exactly this granular, wire center-based line data that I recommend using to identify
14 markets where increased pricing flexibility can appropriately, and safely, be granted (as
15 summarized in my Schedules 1 and 2). Mr. Rowell argues that Cox does "not use wire center
16 boundaries and thus they are unable to tell us how many customers or lines they are serving in
17 each (Qwest) wire center." [Rowell Direct, p. 25] However, that doesn't preclude compiling
18 Cox data that has been reconciled to the Qwest wire center boundaries. If an extreme level of
19 precision were needed, it would only be necessary to obtain the street addresses of each of
20 Cox's customers (or a random sample of those customers), and then to locate these addresses
21 relative to the wire center boundaries. While this may sound difficult, it can be accomplished
22 using highly computerized processes, similar to the methods that are used target direct mail
23 campaigns at specific neighborhoods or sub-markets. On a more simplified basis, roughly the
24 same results can be achieved by relying on ported phone number data. Many customers retain

1 the phone number that was issued by Qwest prior to the time they become a Cox customer.
2 Since in most cases these phone numbers can easily be mapped directly back to the Qwest
3 serving wire center, it is a relatively simple matter to estimate the number of Cox lines that are
4 serving customers that are located within the geographic areas associated with each of Qwest's
5 wire centers. Finally, I would note that Qwest's wire centers are also directly relevant to
6 CLECs who rely on unbundled loops provided by Qwest, since they will generally connect
7 their facilities to these loops at the associated Qwest wire center.

8 At some point in the expansion/entry process, a CLEC will need to analyze individual
9 Qwest wire centers, in evaluating the cost of collocation, the cost of renting Qwest loops versus
10 installing their own facilities, the cost of originating and terminating traffic to Qwest customers in
11 that wire center and so forth. Thus, Qwest wire centers are relevant to all competing carriers,
12 including those who primarily rely on their own facilities.

13 During each step of the entry and network expansion process, the CLEC needs to
14 consider the fixed and variable costs of the entry decision in question, taking into account the
15 fixed cost of collocation and the other investments involved in that entry option. The CLEC will
16 not likely take the next step unless it has a reasonable expectation of recovering its fixed costs
17 over the life cycle of the investment in question. The CLEC might incur collocation costs, costs
18 for various pieces of equipment to be installed in the collocation area, and additional costs
19 required to serve its customers. Throughout this series of decisions, the Qwest wire centers are
20 relevant to their decision making process (although, admittedly, these wire centers are much
21 less important for a cable television carrier like Cox). In general, CLEC entry is not an
22 all-or-nothing decision that occurs exclusively at the county, city, town, or exchange level.

1 Rather, it is typically a sequential process that evolves and changes over time, with many of the
2 key entry decisions occurring at the wire center level or at an even more granular level.

3 Additionally, larger geographic areas such as zip codes (as proposed by Staff) or towns
4 and exchanges (as proposed by Cox) are generally more heterogeneous than individual wire
5 centers. By this I mean that geographic and customer characteristics will vary more widely
6 across a larger area than a smaller one. A town may encompass vastly different
7 neighborhoods with widely varying economic and demographic conditions. Although a town or
8 an exchange may possess a substantial urban component, it is also likely to possess a mixture of
9 both urban and suburban markets. Furthermore, in a state like Arizona, which includes many
10 rural areas, an exchange may include lightly populated rural areas beyond the suburbs.

11 Because competitive conditions are likely to vary as the geographic area studied expands,
12 declaring a service to be competitive (or not) within a relatively large, relatively heterogeneous
13 area has the potential for significant error. Accordingly, I recommend developing the
14 competitive analysis on a more granular basis, focusing on relatively small geographic areas,
15 (like individual wire centers).

16
17 **Q. How do you respond to the concerns expressed by Staff and Cox witnesses that**
18 **customers aren't familiar with wire center boundaries?**

19 **A.** First, it isn't necessary for customers to have familiarity with the geographic boundaries used in
20 administering the price cap plan for the Commission to do its work. Stated another way, once
21 the Commission determines where pricing flexibility will be granted, it will be sufficient to
22 provide affected customers with notice of the fact that Qwest's rates are no longer subject to

1 stringent regulation, and to make sure they are informed of the existence of competitive
2 alternatives, in the event Qwest uses its new-found freedom to raise its prices.

3 Second, if the Commission wants to align its basket assignments with geographic
4 boundaries that are already familiar to customers, it can do so in the final stages of its analysis.
5 If this alignment occurs as a final step, the benefits of using granular wire center data can be
6 retained to a high degree. The Commission can start with a review of HHI and other data for
7 individual wire centers; after determining which wire centers are experiencing the most intense
8 levels of competition, the Commission can look more closely at these specific areas, to
9 determine what existing boundaries (e.g. zip codes) are most closely aligned with, or come
10 closest to encompassing, the wire center areas in question. Thus, for example, if the
11 Commission concludes that competition in the Phoenix main wire center is intense enough to
12 justify additional pricing freedom, it could implement this decision by reclassifying the
13 appropriate services within certain zip codes.

14 I prepared Maps 1 and 2 to illustrate this suggestion. Map 1 centers on the Phoenix -
15 Main wire center and shows the zip codes that overlap the area served by this wire center. As
16 shown on Map 1, zip codes 85003, 85004 and 85007 are almost entirely within the Phoenix -
17 Main wire center boundary. A substantial portion of one other zip code (85006) also falls
18 within the area served by this wire center.

19 Map 2 shows the Tucson - Main wire centers with the zip codes overlaid. As shown,
20 zip codes 85701, 85709, and 85721 lie entirely within the area served by this wire center. In
21 addition, zip code 85713 is largely within the Tucson - Main wire center.
22

1 **Q. Would you please outline other intervenor positions as they relate to adjusting access**
2 **rates?**

3 **A. Yes. MCI, DoD and Staff have all sought intrastate access rate reductions in these**
4 **proceedings. MCI witness Price enumerates his proposal:**

5
6 For all the reasons set forth in my testimony, MCI respectfully urges the
7 Commission to reduce Qwest's Arizona intrastate switched access
8 charges to levels approximating economic cost. If, however, the
9 Commission is unwilling to take such action at this time, at a minimum, it
10 should require Qwest's intrastate switched access rates to mirror its
11 interstate switched access rates. [Price Direct, p. 3]
12

13 DoD witness Lee enumerates his proposal:

14
15 If and when the FCC adopts a change to intercarrier compensation, it
16 will undoubtedly result in a further reduction of interstate access rates.
17 There is nothing to be gained by a further delay in bringing intrastate
18 access rates at least to current interstate rate levels.

19 On the other hand, I agree with Qwest witness Ziegler that this
20 change should be on a revenue neutral basis, with switched access rate
21 reductions offset by an appropriate end-user charge. To minimize rate
22 shock, I recommend that this change be accomplished in two steps,
23 with half of the difference in rates effective upon implementation of the
24 revised price cap plan and full parity a year later. [Lee Direct, p. 11]
25

26 Finally, Staff witness Regan enumerates his proposal:

27
28 I recommend that Qwest's intrastate switched access rates be reduced
29 by 25%. ... This reduction will effectively bring Qwest to "parity" with
30 the Qwest interstate switched access rates (when the interstate EUCL
31 charges are factored into the calculation of the interstate switched
32 access rates), and will bring the Arizona intrastate switched access

1 rates in line with the average intrastate switched access charges of
2 Qwest across its 14 state service territory. [Regan direct, p. 41]
3

4 **Q. How do these recommendations compare to what you recommended for access in your**
5 **direct testimony?**

6 A. Unlike Cox, DoD and Staff, I have not recommended a specific level of access rate reductions,
7 but I did express some concerns about the potential impact of such reductions:

8
9 Switched access service is an important source of revenues that has
10 historically been used to help pay for the costs of providing Universal
11 Service. If these rates are greatly reduced, as some parties are
12 advocating, there will be increased pressure to replace this revenue
13 stream with an alternative source of funding, such as higher local
14 exchange rates. This type of "rate rebalancing," as it has been called,
15 may endanger the universal service goal, particularly if it is implemented
16 in an extreme manner. [Johnson Direct, p. 36]
17

18 While I don't necessarily agree with the Staff proposal – a one-time access rate reduction of
19 \$25 million – it is not as extreme as MCI's proposal, which could lead to drastic dislocations
20 (depending upon how the concept of "economic cost" is interpreted). While DoD's proposal is
21 also somewhat extreme, at least they are proposing that the resulting rate changes be phased in
22 gradually. In this regard, I would like to take this opportunity to reiterate a cautionary note I
23 included in my direct testimony.

24
25 In evaluating this conflicting advice, it would be appropriate to err in the
26 direction of ensuring that the "price of entry" onto the telephone
27 network remains at attractively low levels—thereby helping to maintain
28 very high penetration rates. That is not to say that the Commission
29 should be unwilling to deviate from the status quo, or that it should

1 refuse to consider any reductions to access charges for fear of the
2 consequences. However, the Commission should place a very high
3 burden of proof on parties that are urging extreme changes to cost
4 recovery patterns which have proven so successful for so many years.
5 [Id. p.39]
6

7 Staff witness Abinah indicates that Staff would allow Qwest to recover its access
8 charge reduction through an increase to the "Basket 3 Revenue Cap." Recall that I don't
9 believe a "Basket 3 Revenue Cap" is necessary. For the same reasons I gave earlier, I doubt
10 Qwest would have much success if it attempts to increase rates in Basket 3 in an effort to
11 recoup the revenues lost from the 25% reduction in switched access rates. To that extent, the
12 Staff proposal is not very attractive from Qwest's perspective. MCI and DoD, on the other
13 hand, provide no indication how Qwest would be permitted to recover its access charge
14 reduction under their proposals. Hence, the potential for drastically higher basic local exchange
15 rates, and in turn the risks to universal service, are much greater under the MCI and DoD
16 proposals.

17 I offered a much less risky means of reducing access in my direct testimony:

18
19 While I question the logic or merits of proposals to greatly reduce
20 switched access rates and increase basic exchange rates, under
21 RUCO's recommended Plan the Company will be allowed to gradually
22 rebalance these rates if it so chooses. RUCO's recommended Plan
23 does not include any constraint on annual reductions in switched access
24 rates, so regardless of where these rates are placed within the
25 recommended Plan, Qwest can reduce these rates as rapidly as it
26 chooses. The extent to which it can offset these reductions with
27 increases in other rates will depend the degree of competition facing
28 switched access services, and thus which basket it is placed into. For
29 instance, nothing in the recommended Plan would prevent the Company

1 from reducing its intrastate switched access rates to levels comparable
2 to those charged in the federal jurisdiction, if for some reason it felt this
3 was desirable. [Id., p. 194]
4

5 Because of the various price caps included in RUCO's recommended Plan, the
6 Commission can be confident that any rebalancing that occurs between switched access and
7 other rates will be reasonably gradual, and that offsetting increases in other rates will not be
8 extreme.

9 Finally, I would again call attention to the portion of my recommendations where I
10 endorsed the use of a state Universal Service Fund (USF) as an appropriate long term
11 mechanism for dealing with geographic cost disparities. To the extent Qwest is experiencing
12 insufficient gross profit margins in high cost, rural areas, I recommend moving away from the
13 implicit revenue support that is provided by switched access, to a system that would provide
14 competitively neutral, explicit, targeted support for high cost areas using a state USF. Recall I
15 proposed the following in my direct testimony:

16
17 If the Commission wants to ensure that rural areas (including many of
18 the exchanges classified as UNE Zone 3) generate revenues which are
19 sufficient to cover the relatively high cost of serving these areas, this
20 should not be accomplished by giving Qwest the freedom to drastically
21 increase rural rates. To the contrary, if the Commission is convinced
22 that the existing system of implicit support is not sustainable or
23 acceptable, it would be more appropriate to revamp the Arizona
24 universal service fund that would provide an appropriate mechanism for
25 dealing with these cost disparities. [Id., p. 65]
26

27 Modifying the Arizona USF to more closely resemble the Kansas USF would be a much better

1 solution to the "high cost problem" than Qwest's AUSF proposals and the other intervenors'
2 access proposals. In this regard, it is worth noting that the Kansas Corporation Commission
3 used this mechanism to reduce intrastate access charges to levels rough parity with interstate
4 access charges, and that high cost support is available on a non-discriminatory basis to all
5 qualified carriers serving customers in rural areas, including small and large ILECs (including
6 SBC) as well as CLECs.

7
8 **Q. Does this complete your surrebuttal testimony, which was prefiled on January 12,**
9 **2005?**

10 **A. Yes, it does.**

1 PROPRIETARY EXHIBIT 1

2 for the

3 SUPPLEMENTAL TESTIMONY

4 OF BEN JOHNSON, PH.D.

5 On Behalf of

6 THE STATE OF ARIZONA

7 RESIDENTIAL UTILITY CONSUMER OFFICE

8 Before the

9 ARIZONA CORPORATION COMMISSION

10
11 Docket No. T-01051B-03-0454

12 Docket No. T-00000D-00-0672

13
14 Note 1: Multiple proprietary notes on the same line are noted by a, b, c, etc.

15 Note 2: Proprietary tables in their entirety will follow this list.

16
17 Page Line(s) Proprietary Information
18 22 6
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Proprietary

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Surrebuttal Schedule 1

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Residential Local Exchange Service

Wire Center	Market Share	4-firm Concentration Ratio	HHI	Recommended Basket
PHOENIX-MAIN				Total
TUCSON-MAIN				High
PHOENIX-BETHANY WEST				Moderate
PHOENIX-SOUTHEAST				Moderate
PHOENIX-FOOTHILLS				Moderate
SUNRISE				Moderate
FLOWING-WELLS				Moderate
TUCSON SE				Moderate
CASA GRANDE				Moderate
PHOENIX-PECOS				Moderate
COLDWATER				Moderate
PHOENIX-NORTH				Moderate
SHEA				Moderate
TEMPE-MCCLINTOCK				Moderate
PHOENIX-MARYVALE				Moderate
GILBERT				Moderate
PHOENIX-MID RIVERS				Moderate
PHOENIX-PEORIA				Moderate
CHANDLER-WEST				Moderate
PHOENIX-EAST				Moderate
YUMA-MAIN				Moderate
CRAYCROFT				Moderate
YUMA-SOUTHEAST				Moderate
RINCON				Moderate
SUPERSTITION-WEST				Moderate
CHANDLER-MAIN				Moderate
LITCHFIELD PARK				Moderate
BEARDSLEY				Moderate
PHOENIX-NORTHWEST				Moderate
GLENDALE-MAIN				Moderate
CHANDLER-SOUTH				Moderate
TUCSON-NORTH				Moderate
SCOTTSDALE				Moderate
PHOENIX-WEST				Moderate
PHOENIX-CACTUS				Moderate
TEMPE-MAIN				Moderate
SUPERSTITION-MAIN				Moderate
MESA-MAIN				Moderate
PHOENIX-GREENWAY				Moderate
CORTARO				Moderate
TUCSON-SOUTH				Moderate

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Surrebuttal Schedule 1

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Residential Local Exchange Service

Wire Center	Market Share	4-firm Concentration Ratio	HHI	Recommended Basket
CATALINA				Moderate
TUCSON-EAST				Moderate
DEER VALLEY NORTH				Moderate
PHOENIX-SOUTH				Moderate
PAGE				Moderate
PRESCOTT MAIN				Moderate
CORONADO				Moderate
FLAGSTAFF EAST				Moderate
PINNACLE PEAK				Moderate
THUNDERBIRD				Moderate
PHOENIX-NORTHEAST				Moderate
TOLLESON				Moderate
TANQUE VERDE				Moderate
PHOENIX-SUNNYSLOPE				Moderate
GLOBE				Moderate
FLAGSTAFF MAIN				Moderate
YUMA FORTUNA				Moderate
GREEN VALLEY				Moderate
SUPERSTITION-EAST				Moderate
FORT MCDOWELL				Moderate
CAVE CREEK				Moderate
COTTONWOOD-SOUTH				Moderate
SIERRA VISTA-MN				Moderate
HIGLEY				Moderate
PAYSON				Moderate
PRESCOTT EAST				Moderate
NOGALES				Moderate
SEDONA-MAIN				Moderate
HGLY QUEEN CREEK				Moderate
SEDONA-SOUTH				Moderate
NOGALES MIDWAY				Moderate
TUCSON WEST				Moderate
CHINO VALLEY				Moderate
VAIL SOUTH				Moderate
NEW RIVER				Moderate
PHOENIX-LAVEEN				Moderate
TUCSON SOUTHWEST				Moderate
COTTONWOOD-MAIN				Moderate
MARICOPA				Moderate
HUMBOLDT				Moderate
CIRCLE CITY				Moderate

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Surrebuttal Schedule 1

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Residential Local Exchange Service

Wire Center	Market Share	4-firm Concentration Ratio	HHI	Recommended Basket
STANFIELD				Moderate
WINSLOW				Moderate
WINTERSBURG				Moderate
SAN MANUEL				Moderate
ELOY				Moderate
COOLIDGE				Moderate
MARANA				Moderate
MUNDS PARK				Moderate
SIERRA VISTA NO				Moderate
SUPERIOR				Moderate
WILLCOX				Moderate
TUBAC				Moderate
BUCKEYE				Moderate
BENSON				Moderate
WHITE TANKS				Moderate
MIAMI				Moderate
DUDLEYVILLE				Moderate
JOSEPH CITY				Moderate
FLORENCE				Moderate
TOMBSTONE				Moderate
YARNELL				Moderate
PIMA				Moderate
BLACK CANYON				Moderate
DOUGLAS				Moderate
PALOMINAS				Moderate
CAMP VERDE				Moderate
VAIL NORTH				Moderate
SOMERTON				Moderate
ORACLE				Moderate
WELLTON				Moderate
SAFFORD				Moderate
SAINT DAVID				Moderate
TONTO CREEK				Moderate
FLAGSTAFF SOUTH				Moderate
SIERRA VISTA SO				Moderate
RIO VERDE				Moderate
BISBEE				Moderate
MAMMOTH				Moderate
WILLIAMS				Moderate
PINE				Moderate
GILA BEND				Moderate

Proprietary

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Surrebuttal Schedule 1

Page 4 of 4

Residential Local Exchange Service

Wire Center	Market Share	4-firm Concentration Ratio	HHI	Recommended Basket
<hr/>				
KEARNY				Moderate
ASHFORK				Moderate
WICKENBURG				Moderate
GRAND CANYON				Moderate
HAYDEN				Moderate
PATAGONIA ELGIN				Moderate
PATAGONIA				Moderate
MOUNT LEMMON				Moderate
WHITLOW				Moderate

Proprietary

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Surrebuttal Schedule 2

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Business Local Exchange Service

Wire Center	Market Share	4-firm Concentration Ratio	HHI	Recommended Basket
HUMBOLDT				Total
PHOENIX-MAIN				High or Total
PHOENIX-FOOTHILLS				High
PHOENIX-PECOS				High
SUPERSTITION-MAIN				High
TUCSON-MAIN				High
TUCSON SOUTHWEST				High
CASA GRANDE				Moderate or High
HIGLEY				Moderate or High
HGLY QUEEN CREEK				Moderate or High
MUNDS PARK				Moderate or High
SEDONA-MAIN				Moderate or High
SIERRA VISTA SO				Moderate or High
TANQUE VERDE				Moderate or High
VAIL SOUTH				Moderate or High
SUNRISE				Moderate
ASHFORK				Moderate
BUCKEYE				Moderate
BISBEE				Moderate
BLACK CANYON				Moderate
BENSON				Moderate
SAINT DAVID				Moderate
BEARDSLEY				Moderate
CHANDLER-MAIN				Moderate
CHANDLER-SOUTH				Moderate
CHANDLER-WEST				Moderate
CHINO VALLEY				Moderate
COOLIDGE				Moderate
CAMP VERDE				Moderate
CIRCLE CITY				Moderate
CORONADO				Moderate
COTTONWOOD-MAIN				Moderate
COTTONWOOD-SOUTH				Moderate
CAVE CREEK				Moderate
DUDLEYVILLE				Moderate
DOUGLAS				Moderate
DEER VALLEY NORTH				Moderate
ELOY				Moderate
FLAGSTAFF EAST				Moderate
FLAGSTAFF MAIN				Moderate
FLAGSTAFF SOUTH				Moderate

Proprietary

Docket No. T-01051B-03-0454

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Surrebuttal Schedule 2

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Business Local Exchange Service

Wire Center	Market Share	4-firm Concentration Ratio	HHI	Recommended Basket
FLORENCE				Moderate
FORT MCDOWELL				Moderate
RIO VERDE				Moderate
COLDWATER				Moderate
GILA BEND				Moderate
GLENDALE-MAIN				Moderate
GLOBE				Moderate
GREEN VALLEY				Moderate
GRAND CANYON				Moderate
HAYDEN				Moderate
JOSEPH CITY				Moderate
KEARNY				Moderate
LITCHFIELD PARK				Moderate
MARANA				Moderate
GILBERT				Moderate
MESA-MAIN				Moderate
MIAMI				Moderate
MAMMOTH				Moderate
MARICOPA				Moderate
NOGALES				Moderate
NOGALES MIDWAY				Moderate
NEW RIVER				Moderate
ORACLE				Moderate
PAGE				Moderate
PHOENIX-BETHANY WEST				Moderate
PHOENIX-CACTUS				Moderate
PHOENIX-EAST				Moderate
PHOENIX-GREENWAY				Moderate
PHOENIX-LAVEEN				Moderate
PHOENIX-MID RIVERS				Moderate
PHOENIX-MARYVALE				Moderate
PHOENIX-NORTHEAST				Moderate
PHOENIX-NORTH				Moderate
PHOENIX-NORTHWEST				Moderate
PHOENIX-PEORIA				Moderate
PHOENIX-SOUTHEAST				Moderate
PHOENIX-SOUTH				Moderate
PHOENIX-SUNNYSLOPE				Moderate
PHOENIX-WEST				Moderate
PIMA				Moderate
PINE				Moderate

Proprietary

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Surrebuttal Schedule 2

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Business Local Exchange Service

Wire Center	Market Share	4-firm Concentration Ratio	HHI	Recommended Basket
PALOMINAS				Moderate
PRESCOTT EAST				Moderate
PRESCOTT MAIN				Moderate
PINNACLE PEAK				Moderate
PATAGONIA ELGIN				Moderate
PATAGONIA				Moderate
PAYSON				Moderate
SCOTTSDALE				Moderate
SHEA				Moderate
THUNDERBIRD				Moderate
SEDONA-SOUTH				Moderate
SAFFORD				Moderate
SOMERTON				Moderate
SAN MANUEL				Moderate
SUPERIOR				Moderate
SUPERSTITION-EAST				Moderate
SUPERSTITION-WEST				Moderate
SIERRA VISTA-MN				Moderate
SIERRA VISTA NO				Moderate
STANFIELD				Moderate
CATALINA				Moderate
CORTARO				Moderate
CRAYCROFT				Moderate
TUCSON-EAST				Moderate
FLOWING-WELLS				Moderate
MOUNT LEMMON				Moderate
TUCSON-NORTH				Moderate
RINCON				Moderate
TUCSON SE				Moderate
TUCSON-SOUTH				Moderate
TUCSON WEST				Moderate
TEMPE-MAIN				Moderate
TEMPE-MCCLINTOCK				Moderate
TOLLESON				Moderate
TOMBSTONE				Moderate
TONTO CREEK				Moderate
TUBAC				Moderate
VAIL NORTH				Moderate
WICKENBURG				Moderate
WHITE TANKS				Moderate
WHITLOW				Moderate

Proprietary

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Surrebuttal Schedule 2

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Business Local Exchange Service

Wire Center	Market Share	4-firm Concentration Ratio	HHI	Recommended Basket
<hr/>				
WILLCOX				Moderate
WILLIAMS				Moderate
WELLTON				Moderate
WINTERSBURG				Moderate
WINSLOW				Moderate
YARNELL				Moderate
YUMA FORTUNA				Moderate
YUMA-MAIN				Moderate
YUMA-SOUTHEAST				Moderate

Map1: Phoenix-Main (PHNXAZMA) wire center with zip code overlay

The map displays the PHNXAZMA wire center in light blue, with the following zip codes overlaid: 85003, 85004, 85006, 85007, 85009, 85017, and 85034. Surrounding wire centers include GLDLAZMA, PHNXAZMY, PHNXAZLV, KMTKAZXA, PHNXAZNO, PHNXAZNE, SCDLAZTH, SCDLAZMA, TEMPAMZA, PHNXAZSE, CHINDAZWE, and TEMPAMC.

SCDLAZTH

PHNXAZNW

85017

PHNXAZNO

PHNXAZNE

SCDLAZMA

PHNXAZMY

TL SNAZMA

PHNXAZWE

PHNXAZMA

ДНХДЗЕА

TEMPAZMA

PHNXAZSE

PHNXAZSO

PHNXAZLV

TEMPAZMC

KMTKAZXA

CHNDAZWE

Map 2: Tucson-Main (TCSNAZMA) wire center with zip code overlay

